PART V: BONDS

Short-Term Taxable Obligations (Maturities One Year or Less)

7611. What is a Treasury bill?

Treasury bills (T-bills) are obligations of the United States Government, generally issued with 4-week, 13-week, 26-week, and 52-week maturity periods. Treasury bills are issued in minimum denominations of $100 with $100 increments thereafter. Treasury bills are issued without interest and on a discount basis (that is, they are issued at a price that is less than the amount for which they will be redeemed at maturity). The price is determined at auction. (13- and 26-week bills are generally auctioned on Monday of each week; 4-week bills are generally auctioned on Tuesday of each week; 52-week bills are generally auctioned every four weeks on Tuesday).

7612. Is an investor who holds a T-bill required to include interest in income prior to sale or maturity of the bill?

No. The amount of interest, represented by the discount (at issue or on the market) from face value, is not required to be included in income by a cash basis investor until the date on which the obligation is paid at maturity, sold, or otherwise disposed of as discussed in Q 7613.[1]

However, a cash basis investor may elect to include in income as it accrues prior to sale or redemption the difference between the stated redemption price at maturity and his or her basis in the obligation (this difference is called "acquisition discount"). Such an election may not be limited to a particular bill, but applies to all short-term taxable obligations acquired on or after the first day of the first taxable year for which the election is made, and it continues to apply until the Service consents to revocation of the election.[2] (Short-term obligations are those having a fixed maturity date of one year or less after issue).[3] The election affects short-term taxable corporate obligations as well; however, in the case of corporate obligations, original issue discount is included unless the investor chooses to include "acquisition discount" with respect to all of them.[4] With respect to interest-paying, short-term corporate obligations, elections to include discount as it accrues will also have the effect of requiring the taxpayer to include stated interest payments (not otherwise includable in income until paid) in income as they accrue.[5] See also Q 7614.

Under the election, acquisition discount is considered to accrue daily on a ratable basis. That is, the amount of discount is divided by the number of days after the day the taxpayer

1. IRC Secs. 454(b), 1272(a)(2).
2. IRC Sec. 1282(b)(2).
3. IRC Sec. 1283(a).
4. IRC Sec. 1283(c).
5. IRC Sec. 1281(a)(2).

acquired the obligation up to and including the day of its maturity.[1] The taxpayer must include an amount equal to the sum of the daily portions for each day in the tax year he or she held the obligation.[2] However, a taxpayer electing to include acquisition discount as it accrues may elect, under regulations, with respect to particular obligations, a constant interest rate (using yield to maturity based on the cost of the bill and daily compounding) and use ratable accrual on other short-term obligations. Once made, this election is irrevocable with respect to the obligations to which it applies.[3]

This election may, under some circumstances, be advantageous where leveraging is used by a cash basis investor to purchase or carry Treasury bills, since deduction of the interest expense up to the amount of discount accruing during the year must be deferred unless discount is currently included (see Q 7944).

While a cash basis investor is not usually required to include discount in income prior to sale or other disposition, certain taxpayers must include acquisition discount in income. The mandatory accrual rules apply to bills (1) held by accrual basis taxpayers, (2) held by a bank, (3) held by a regulated investment company or common trust fund, (4) held as inventory, (5) identified[4] as part of a hedging transaction, or (6) held by a pass-through entity (e.g., a trust, partnership, or S corporation) formed or availed of to avoid the mandatory inclusion rule, or a pass-through entity in any year in which taxpayers who would be subject to the rule own 20 percent or more of the value of the interests in the entity for 90 days or more.[5] A taxpayer subject to these mandatory accrual rules may, under regulations, elect irrevocably to accrue discount with respect to any obligation on a constant rate (compounded daily) instead of ratably.[6]

The basis of a T-bill is increased by amounts of accrued discount and interest included in income prior to disposition or redemption.[7]

7613. How is an investor taxed on the gain or loss on the sale or maturity of a Treasury bill?

T-bills are capital assets.[8] On sale or maturity of the bill, the seller recovers the tax basis (generally cost plus broker's fees on acquisition) tax-free. Any gain realized over the tax basis must be treated as ordinary income to the extent it represents recovery of discount. Any excess over that is capital gain.[9] (Generally, the gain is short-term because the holding period for short-term gain is one year or less.[10] See Q 608 for the treatment of capital gains and losses.)

1. IRC Sec. 1283(b)(1).
2. IRC Sec. 1281(a).
3. IRC Sec. 1283(b)(2).
4. Under IRC Sec. 1256(e).
5. IRC Sec. 1281(b).
6. IRC Sec. 1283(b)(2).
7. IRC Sec. 1283(d).
8. IRC Sec. 1221.
9. IRC Sec. 1271(a)(3).
10. IRC Sec. 1222.

The amount of discount treated as ordinary income is determined in the following manner. Any individual holding the bill at maturity includes as ordinary income the difference between the tax basis and the bill's face value. (The difference between an individual's basis and the bill's face value is called "acquisition discount"). Any individual who sells the bill prior to maturity includes as ordinary income only a portion of the acquisition discount based on the total time he or she held the bill; the amount included is the acquisition discount multiplied by a fraction having as numerator the number of days the individual held the obligation and as denominator the number of days after he or she acquired the bill up to and including the maturity date.[1] This formula enables each holder to determine the portion of any gain to be treated as interest income without reference to the original discount or the treatment applicable to any other holder.

An owner may elect irrevocably on a bill-by-bill basis to compute the amount of discount on a daily compounding basis instead of in equal daily portions.[2]

If the investor has elected to include discount in income as it accrues prior to sale, the tax basis is increased by the amount included, and the entire gain is capital gain (see Q 7612).[3]

If instead of a gain, loss is realized on sale or maturity, it is a capital loss.

The installment method for recognizing and taxing gain is not available for securities traded on an established securities market. As a result, gain from sale is included in income for the year in which the trade date occurs even if one or more payments are received in the subsequent tax year.[4]

The interest is exempt from all state and local income taxes.[5]

If a Treasury bill was held as part of a tax straddle, the additional rules and qualifications explained in Q 7587 to Q 7603 apply; if a Treasury bill was held as part of a conversion transaction, the additional rules explained in Q 7604 and Q 7605 apply.

If the transfer is between spouses, or between former spouses incident to divorce, see Q 660.[6]

7614. Is an investor who holds a short-term taxable corporate obligation required to include discount in income prior to sale or maturity? Is an investsor required to include interest as it accrues?

Original issue discount (the difference between the issue price and the stated redemption price) on a taxable corporate debt instrument having a maturity date of one year or less is generally not included in income by a cash basis investor prior to sale or redemption.[7] Interest payable on such bonds is generally not included in income by a cash basis taxpayer until it is received.

1. IRC Sec. 1271(a)(3).
2. IRC Sec. 1271(a)(3)(E); Treas. Reg. §1.1271-1(b)(2).
3. IRC Sec. 1283(d).
4. IRC Sec. 453(k). See Rev. Rul. 93-84, 1993-2 CB 225.
5. 31 USC 3124.
6. IRC Sec. 1041.
7. IRC Sec. 1272(a)(2).

However, a cash basis investor may elect to include original issue discount as it accrues. Such an election may not be limited to a particular obligation but applies to all short-term taxable corporate obligations (and to Treasury bills with respect to acquisition discount) acquired on or after the first day of the first taxable year for which the election is made, and it continues to apply until the Service consents to revocation of the election.[1] If a taxpayer elects to include discount as it accrues, he or she must also include stated interest (not otherwise included in income until it is paid) as it accrues.[2]

The taxpayer making the election must include as income an amount equal to the sum of the daily portions of original issue discount (in the case of T-bills, daily portions of acquisition discount) for each day that the taxpayer held the obligation in the tax year.

An irrevocable election may be made, on an obligation-by-obligation basis, to determine the amount of original issue discount by using daily compounding at a constant interest rate.[3]

Rather than electing to include original issue discount as it accrues, a taxpayer may elect to include "acquisition discount" (the difference between the stated redemption price at maturity and the basis in the obligation) as it accrues.[4] The manner in which acquisition discount accrues is discussed in Q 7612. The election to accrue acquisition discount applies to all such obligations (and Treasury bills) acquired by the taxpayer on or after the first day of the first taxable year to which the election applies and thereafter until the Service consents to a revocation.

Certain investors *must* include original issue discount (or, by election, acquisition discount) in income prior to sale or other disposition of corporate short-term taxable obligations. They must also include interest payable on the obligation as it accrues.[5] The mandatory inclusion rules apply to obligations if they are: (1) held by accrual basis taxpayers; (2) held by a bank; (3) held by a regulated investment company or common trust fund; (4) held as inventory; (5) identified as part of a hedging transaction;[6] or (6) held by a pass-through entity (e.g., a trust, partnership or S corporation) formed or availed of to avoid the mandatory inclusion rule, or a pass-through entity in any year in which taxpayers who would be subject to the rule held 20 percent or more of the value of the interests in the entity for 90 days or more.[7] Discount must also be included in income as it accrues on a stripped bond or stripped coupon held by the person who stripped the bond or coupon or by a person whose basis is determined by reference to the basis in the hands of the person who stripped the bond or coupon (e.g., a person who receives it as a gift) (see Q 7656).[8]

The basis of a short-term taxable corporate obligation is increased by amounts of accrued discount included in income prior to disposition or redemption.[9] As to how gain or loss is treated

1. IRC Secs. 1282(b), 1283(c).
2. IRC Sec. 1281(a)(2).
3. IRC Sec. 1271(a)(4); Treas. Reg. §1.1271-1(b)(2).
4. IRC Sec. 1283(c)(2).
5. IRC Sec. 1281(a).
6. Under IRC Sec. 1256(e).
7. IRC Sec. 1281(b).
8. IRC Sec. 1281(b)(1)(F).
9. IRC Sec. 1283(d).

upon disposition of corporate short-term taxable obligations with original issue discount when the taxpayer has not made an election to include discount as it accrues, see Q 7615.

7615. How is an investor taxed on gain or loss on the sale or maturity of a short-term taxable corporate obligation?

As a general rule, gain or loss is a capital gain or loss. However, gain on the sale or redemption of short-term corporate obligations is ordinary income up to the portion of the original issue discount allocable to the time the obligation was held by the taxpayer (and not included in income as it accrued).[1] Original issue discount is the difference between the stated redemption price and the issue price.[2]

The share of original issue discount allocable to the taxpayer is the amount that bears the same ratio to the total discount as the number of days the obligation was held to the number of days after the issue date, up to and including the date of maturity of the obligation. An irrevocable election may be made, on an obligation-by-obligation basis, to determine the amount using daily compounding at a constant interest rate.[3]

Short-term corporate obligations are not subject to the market discount rules that require market discount to be treated as ordinary income on disposition.[4] Therefore, any excess amount realized on sale after recovery of basis and original issue discount not previously included in income (see Q 7614) is treated as capital gain.[5] See Q 605 regarding holding periods and Q 608 for the treatment of capital gains and losses.

If the taxpayer has a loss resulting from a sale to a related person (see Q 607), the loss may not be deducted or used to offset other capital gains.[6]

If "substantially identical" securities are acquired within 30 days before or 30 days after a sale that results in a loss, the loss deduction will be disallowed under the wash sale rules (see Q 7535), but the amount of loss disallowed is added to the basis of the new property.[7]

The installment method for reporting gain is not available for securities traded on an established securities market. As a result, gain from sale is included in income for the year in which the trade date occurs even if one or more payments are received in the subsequent tax year.[8]

Generally, neither gain nor loss is recognized on a transfer between spouses, or between former spouses if incident to divorce (see Q 660).[9]

1. IRC Sec. 1271(a)(4).
2. IRC Sec. 1273(a).
3. IRC Sec. 1271(a)(4); Treas. Reg. §1.1271-1(b)(2).
4. IRC Sec. 1278(a)(1)(B)(i).
5. IRC Sec. 1271(a)(3)(A).
6. IRC Sec. 267(a).
7. IRC Sec. 1091.
8. IRC Sec. 453(k). See Rev. Rul. 93-84, 1993-2 CB 225.
9. IRC Sec. 1041.

Interest expense and short sale expense that were not deductible in the previous year because of the deferred taxability of the discount or interest (see Q 7944) are deductible in the year the obligation is sold or redeemed, whether at a gain or loss.[1]

If a corporate obligation was held as part of a tax straddle, the additional rules and qualifications explained in Q 7587 to Q 7603 apply. If a corporate obligation was held as part of a conversion transaction, the additional rules discussed in Q 7604 and Q 7605 apply.

7616. Are interest expenses deductible if Treasury bills or short-term taxable corporate obligations are purchased or carried with borrowed funds?

Deduction of interest paid on amounts borrowed by a taxpayer to purchase or carry Treasury bills or short-term taxable corporate obligations may be subject to limitation and deferral. See Q 7944 for details.[2] Certain short sale expenses (see Q 7529, Q 7530) may be treated as interest within this rule.[3] Any deductible interest expense will also be subject to the general limit on otherwise allowable investment interest expense deductions (see Q 7941).

Treasury Bonds and Notes

7617. What are Treasury bonds and Treasury notes?

Treasury bonds and notes are obligations of the federal government. They are essentially similar, except that bonds mature in more than 10 years while Treasury notes have maturity dates ranging from one to 10 years. (Thirty-year bonds are auctioned quarterly in February, May, August, and November, with re-openings in the other eight months). These obligations are issued in denominations ranging from $100 to $5,000,000. Bonds issued after September 3, 1982, and notes issued after 1982 must be in registered form (see Q 7682); however, bearer bonds and notes issued before the registration requirement date may continue to be bought and sold in bearer form. Bearer notes and bonds have coupons attached that are cut off and redeemed, generally through a commercial bank or the Federal Reserve Bank (or a branch). In the case of registered obligations, interest payments are paid to the registered owner by the Treasury Department. Interest is generally payable on these obligations every six months. They are redeemable at maturity for face value.

7618. What does the holder of a Treasury note or bond include in annual income?

(1) Unless the note or bond was issued before March 1, 1941 (in which case it may be only partly taxable), stated interest that accrues after the date of purchase is included as ordinary income in the year in which it is received or made available (i.e., as a general rule, the date the coupon becomes due or the interest check is received).[4] If an individual purchased the bond between interest dates and paid the seller interest accrued but not yet due at the date of purchase, the individual does not deduct the amount or include it in basis; instead, he or she

1. IRC Sec. 1282(c).
2. IRC Sec. 1282(a).
3. IRC Sec. 1282(c).
4. Treas. Regs. §§1.61-7, 1.451-2(b); *Lavery v. Comm.*, 158 F.2d 859 (7th Cir. 1946); *Obland v. U.S.*, 67-2 USTC ¶9751 (E.D. Mo. 1967).

recovers that amount tax-free out of the first interest payment received and includes in income only the balance.[1]

(2) If the bond or note was originally issued at a discount (that is, at a price below the stated maturity or face amount) after July 1, 1982, any holder who did not pay more than the face value of the obligation must include in income each year a daily share of the "original issue discount" as discussed in Q 7635. (A discount of less than ¼ of 1 percent (.0025) times the number of years from issue to maturity may be disregarded. This is normally the case with Treasury notes and bonds).[2] The holder's basis is increased by the amount of original issue discount actually included in income each year.[3]

However, if the obligation was originally issued before July 2, 1982, the amount of discount is not includable in income until it is received on sale or maturity of the obligation (see Q 7619).[4]

(3) Market discount accrued during the year on notes and bonds (acquired in tax years ending after July 18, 1984) must be included in income if an election to include market discount is in effect (see Q 7629).

(4) If the holder purchased the bond at a premium, he or she may elect to amortize the premium and reduce his basis accordingly (see Q 7639).

For tax on the sale or exchange of a Treasury bond or note, see Q 7619.

7619. How are the proceeds taxed on sale or redemption of Treasury notes and bonds?

On sale or on redemption at maturity, the proceeds must be separated into identifiable components for tax purposes.

(1) If the sale occurs between interest dates, as it generally does, the seller usually receives from the buyer an amount stated separately from the purchase price representing stated interest accrued to the date of sale, but not yet due. This is reported by the seller as interest income, not gain.[5]

(2) Out of the proceeds (other than interest, discussed above) an amount equal to the taxpayer's adjusted basis in the note or bond and expenses of sale is recovered tax-free.[6] The taxpayer's basis is generally the cost of acquisition adjusted by (i) adding any original issue discount and market discount included in income as it accrued,[7] *or* (ii) subtracting the amount of premium deductible or applied to reduce interest payments over the period the taxpayer held the bond if he or she elected to amortize the premium (see Q 7629, Q 7635, Q 7639).[8]

1. *L.A. Thompson Scenic Ry. Co. v. Comm.*, 9 BTA 1203 (1928); Rev. Rul. 69-263, 1969-1 CB 197.
2. IRC Sec. 1273(a).
3. IRC Sec. 1272(d).
4. IRC Sec. 1271(b); Treas. Reg. §1.67-7(c).
5. Treas. Reg. §1.61-7(d).
6. IRC Sec. 1001(a).
7. IRC Secs. 1272(d), 1276(d)(2), 1278(b)(4); General Explanation–TRA '84, p. 99.
8. IRC Sec. 1016(a)(5).

(3) As a general rule, amounts in excess of (1) and (2) are treated as capital gain–long-term or short-term–depending on the holding period and the date of acquisition. See Q 605 and Q 608 for more information on the calculation of holding periods and the treatment of capital gains and losses. However, in special circumstances part or all of the gain must be treated as ordinary income:

(a) If the note or bond was issued after July 18, 1984, or if the note or bond was issued on or before July 18, 1984, and was purchased on the market after April 30, 1993, gain equal to market discount accrued up to the date of disposition and not previously included in income is treated as interest income, not capital gain (see Q 7630, Q 7632).[1] If a bond was issued on or before July 18, 1984, but acquired after that date at a market discount using *borrowed funds*, a part or all of the gain must be treated as ordinary income to the extent that a deferred interest expense deduction is taken (see Q 7945).

(b) If a note or bond originally issued on or before July 1, 1982, and after December 31, 1954, was originally issued at a discount of ¼ of 1 percent (.0025) or more of the stated redemption price multiplied by the number of full years from issue to maturity and the holder did not pay a premium for it, any *gain* realized must be treated as ordinary income up to a prorated portion of the original issue discount.[2] (The prorated portion is explained in Q 7636).

If the seller purchased the note or bond at a premium (i.e., at a price in excess of the face amount of the obligation), none of the gain is original issue discount.[3] A holder is considered to have purchased at a premium if the holder's basis is the same, in whole or in part, for purposes of determining gain or loss from a sale or exchange as the basis in the hands of another person who purchased at a premium. Thus, for example, a donee is considered to have purchased at a premium if the donor did.[4]

(c) With respect to bonds issued before January 1, 1955, the IRC did not deal with the problem of original issue discount. Despite this, the Supreme Court has ruled that under the pre-1954 Code, original issue discount "serves the same function as stated interest" and "earned original issue discount, like stated interest, should be taxed … as ordinary income" when realized.[5] However, gain or loss from *retirement* of a bond is capital gain or loss only if the bond was issued with coupons attached or in registered form or was in such form on March 1, 1954.[6]

(4) If there was no gain, the loss is treated as a capital loss–long-term or short-term–depending on the length of the holding period (see Q 605). If "substantially identical" obligations were acquired (or a contract to acquire them was made) within 30 days before or 30 days after the sale, the loss will be subject to the "wash sale" rule discussed in Q 7535. If the sale is made to a related person, the loss deduction may be disallowed (see Q 607).

1. IRC Sec. 1276.
2. IRC Sec. 1271(c)(2).
3. IRC Sec. 1271(a)(2)(B).
4. Treas. Reg. §1.1232-3(d)(2).
5. *U.S. v. Midland-Ross Corp.*, 381 U.S. 54 (1965).
6. IRC Sec. 1271(c).

If a Treasury bond or note was held as part of a tax straddle, the additional rules and qualifications explained in Q 7587 to Q 7603 apply; if the bond or note was held as part of a conversion transaction, the additional rules discussed in Q 7604 and Q 7605 will apply.

For the rules governing the substitution of newly issued bonds for outstanding bonds, see Rev. Proc. 2001-21.[1]

7620. When does the holding period begin if Treasury notes and bonds were bought at auction or on a subscription basis?

The holding period of United States Treasury notes and bonds sold at auction on the basis of yield generally starts the day after the Secretary of the Treasury, through news releases, gives notification of his or her acceptance of successful competitive and noncompetitive bids. The holding period of Treasury bonds and notes sold through an offering on a subscription basis at an established yield generally starts the day after the subscription is submitted.[2] (Under some circumstances, a holding period may be tolled or be deemed to have begun at a later date. See, for example, the rules for tax straddles (Q 7587 to Q 7603).

The donee of a bond can include in his holding period the time the bond was held by the donor.[3]

Corporate Bonds

7621. What amounts are included in current income by an investor who holds a taxable corporate bond?

(1) Interest that accrues after the date of purchase is included as ordinary income in the year in which it is received or made available.[4] As a general rule, interest is considered received on the date the interest check is received, if the bond is registered, or on the date the coupon matures, in the case of a bearer coupon bond.[5] (See Q 579 for an explanation of the doctrine of constructive receipt). If the investor purchased the bond between interest dates and the investor paid the seller interest accrued but not yet due at that time, he or she receives that amount as a tax-free return of capital out of the first interest payment received. The investor includes in income only the balance of the interest.[6] If principal or interest was in default at the time of purchase and the bond traded without allocation of price between principal and accrued interest, see Q 7653.

(2) If the holder purchased the bond at a premium, he or she may elect to amortize a part of the premium each year and reduce basis by the amount deductible (or applied to reduce interest payments) (see Q 7639).

1. 2001-1 CB 742.
2. Rev. Rul. 78-5, 1978-1 CB 263.
3. IRC Sec. 1223(2).
4. Treas. Reg. §1.61-7.
5. Treas. Reg. §1.451-2(b); *Lavery v. Comm.*, 158 F.2d 859 (7th Cir. 1946); *Obland v. U.S.*, 67-2 USTC ¶9751 (E.D. Mo. 1967).
6. *L.A. Thompson Scenic Ry. Co. v. Comm.*, 9 BTA 1203 (1928); Rev. Rul. 69-263, 1969-1 CB 197.

(3) Unless the bondholder purchased the bond at a premium (i.e., at an amount in excess of the face value of the bond), the holder of a bond originally issued at a discount after May 27, 1969, must include in income a portion of the original issue discount. However, if the discount at issue was less than ¼ of 1 percent (.0025) of the stated redemption price multiplied by the number of full years from the date of original issue to maturity, the bond is treated as if it were not issued at a discount and no part of the discount is included in income as it accrues.[1] Original issue discount on bonds issued after May 27, 1969, and on or before July 1, 1982, accrues as discussed in Q 7637. Original issue discount on bonds issued after July 1, 1982, accrues as discussed in Q 7635.

(4) If the bond was issued after July 18, 1984, or if the bond was issued on or before July 18, 1984, and was purchased after April 30, 1993, and the purchase occurred on the market at a discount of ¼ of 1 percent (.0025) or more of the stated redemption price at maturity multiplied by the number of years until maturity, a cash basis investor must include the market discount in income as it accrues *if* he or she has made an election to include accrued market discount with respect to that bond or other market discount obligations, as discussed in Q 7629.[2]

(5) Any partial payment of principal on a market discount bond acquired after October 22, 1986, is treated as a payment of market discount and included in income to the extent that market discount has accrued up to that time.[3] Where principal is to be paid in two or more payments, the amount of accrued market discount will be determined under regulations.[4]

7622. How are proceeds on the sale or retirement of a corporate bond taxed?

(1) If the sale occurs between interest due dates, as it generally does, stated interest accrued to the date of sale but not yet due is customarily added to the purchase price. This must be included in the seller's income as interest.[5]

(2) Proceeds in excess of item (1), above, are recovered tax-free to the extent of the investor's adjusted basis in the bond.[6] As a general rule, the investor's adjusted basis is the cost of acquisition adjusted by (a) adding any original issue discount included in income as it accrued (see Q 7635, Q 7637) and market discount included in income prior to the sale (see Q 7629, Q 7631, Q 7632), or (b) subtracting amounts of premium deductible or applied to reduce interest payments if an election was made to amortize bond premium (see Q 7639).

(3) Ordinarily, amounts in excess of interest and basis are treated as capital gain – long-term or short-term, depending on the investor's holding period. See Q 605 regarding holding periods and Q 608 for the treatment of capital gains and losses. However, if the bond was originally issued at a discount or was purchased on the market at a discount, part or all of the gain must

1. IRC Secs. 1272(a), 1272(b), 1273(a)(3); see Treas. Reg. §1.1232-3.
2. See IRC Sec. 1278(b).
3. IRC Sec. 1276(a)(3).
4. IRC Sec. 1276(b)(3).
5. Treas. Reg. §1.61-7(d).
6. IRC Sec. 1001(a).

be treated as interest instead of capital gain, if the discount was not included in income as it accrued. (Discount that is less than ¼ of 1 percent (.0025) of face value multiplied by the number of complete years to maturity is considered no discount).

(a) If the bond was issued after July 18, 1984, or if the bond was issued on or before July 18, 1984, and purchased on the market after April 30, 1993, gain to the extent it does not exceed market discount must be treated as interest income, not capital gain (see Q 7628, Q 7630, Q 7632). If a bond issued on or before July 18, 1984 was acquired after July 18, 1984, but before May 1, 1993, at a market discount using borrowed funds, a part of the gain must be treated as ordinary income if a deferred interest expense deduction is taken (see Q 7945).

(b) If the bond was originally issued at a discount of ¼ of 1 percent (.0025) or more of the face amount multiplied by the number of full years from issue to maturity and the seller had not purchased the bond at a premium, a part of any *gain* realized is treated as ordinary income in the following cases:

If the bond was issued after May 27, 1969, original issue discount is includable in income annually (see Q 7635, Q 7637) and basis is adjusted for amounts included.[1] However, if at the time of original issue there was an intention to call the bond in for redemption before maturity, gain on sale or redemption is ordinary income up to the entire amount of the original issue discount reduced by the portions of original issue discount previously includable in income by any holder.[2] An intention to call is discussed in Q 7638. The amount of original issue discount allocable to each day, in the case of bonds issued after July 1, 1982, is discussed in Q 7635; the amount allocable to each month in the case of bonds issued on or before July 1, 1982, and after May 27, 1969, is discussed in Q 7637.

If the bond was issued on or before May 27, 1969, and after December 31, 1954, any gain realized on sale or redemption is taxed as ordinary income to the extent of an amount that bears the same ratio to the total original issue discount as the number of full months the bond was held by the taxpayer bears to the number of full months from issue date to maturity date. Days amounting to less than a full month are not counted. The period the taxpayer held the bond must include any period it was held by another person if the bond has the same basis, in whole or in part, in the taxpayer's hands as it would have in the hands of the other person.[3] However, if there was an intention at the time of issue to call the bond before maturity, gain up to the entire original issue discount is included as ordinary income.[4]

If the obligation was issued before 1955, the Supreme Court has ruled that original issue discount serves the same purpose as interest and should be taxed as ordinary income rather than capital gain.[5]

(4) If there was a *loss* on the sale or redemption, no original issue discount or market discount is recovered. Loss will be treated as a capital loss. However, if "substantially identical" obligations

1. IRC Sec. 1272(d)(2).
2. IRC Sec. 1271(a)(2).
3. See Treas. Reg. §1.1232-3(c).
4. IRC Sec. 1271(c).
5. *U.S. v. Midland-Ross Corp.*, 381 U.S. 54 (1965).

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 discussed in Q 7535. If the sale is made to a related party, the loss deduction may be disallowed (see Q 607).

(5) Amounts received on retirement are treated as amounts received on sale (but for obligations issued before 1955, only if the obligation was in coupon or registered form on March 1, 1954).[1]

The installment method for reporting gain is not available for securities traded on an established securities market. As a result, gain from sale is included in income for the year in which the trade date occurs even if one or more payments are received in the subsequent tax year.[2]

If a corporate bond was held as part of a tax straddle, the additional rules and qualifications explained in Q 7587 to Q 7603 apply. If a bond was held as part of a conversion transaction, the additional rules discussed in Q 7604 and Q 7605 will apply.

If principal or interest was in default and the bond was bought or sold "flat," see Q 7653.

Generally, neither gain nor loss is recognized on a transfer between spouses, or between former spouses if incident to divorce (see Q 660).[3]

7623. How is the donor of a corporate bond taxed on interest that has accrued prior to the date of the gift?

Interest accrued, but not yet due, on corporate bonds (and Treasury bonds and notes) before the date of a gift is includable as ordinary income in the donor's income for the taxable year during which the bond interest is actually or constructively received by the donee. Therefore, the donor will not necessarily be taxed on such income in the year in which the gift is made. Amounts received from interest accruing after the transfer date are includable in the gross income of the donee.[4]

For treatment of accrued market discount in a disposition by gift, see Q 7631. See Q 7660 regarding gifts of Series E and EE bonds.

7624. How is a convertible bond taxed on conversion?

Ordinarily, a convertible bond is one exchangeable, at the holder's option, into a specified number of the company's common shares at a fixed price within a certain time period–usually up to the maturity of the bond. A bond may also be issued in such a form as to grant to the holder a right to convert the bond into another debt instrument of the issuing company.

Gain or loss is not recognized when, under the terms of a bond convertible into stock of the issuing corporation, the bond is exchanged for (converted into) that stock. This is true whether

1. IRC Secs. 1271(a), 1271(c).
2. IRC Sec. 453(k). See Rev. Rul. 93-84, 1993-2 CB 225.
3. IRC Sec. 1041.
4. Rev. Rul. 72-312, 1972-1 CB 22.

or not the fair market value of the stock exceeds the holder's adjusted basis in the bond and any additional amount paid on exercise of the conversion right. The holder's basis in the stock is the adjusted basis in the bond plus any amount paid on conversion.[1] It is unclear whether the same tax treatment would apply upon the conversion of a bond convertible into another bond of the issuer.

The conversion of a bond (in accordance with its terms) into stock of a different corporation is a taxable event (see Q 7622).[2]

For the treatment of original issue discount in the case of a convertible bond, see Q 7625.

For the treatment of the sale of stock acquired on conversion of a market discount bond, see Q 7633.

For the treatment of a convertible bond that is part of a *conversion transaction* (as defined in IRC Section 1258), see Q 7604 and Q 7605.

7625. How is original issue discount determined in the case of a convertible bond?

No adjustment is made for the value of the conversion feature of a bond convertible into stock or another debt instrument of the issuer or a related party in calculating the bond's issue price for purposes of determining whether the bond was issued at an original issue discount.[3] Under regulations, the issue price of a bond convertible into stock or another debt instrument of the issuer includes any amount paid for the conversion privilege, even if the privilege may be satisfied for the cash value of the stock or other debt instrument.[4] For debt instruments issued on or after February 5, 2013, this includes the equity interests of entities classified as partnerships as well as those classified as corporations for tax purposes. Although the regulations are effective for bonds issued after April 3, 1994, taxpayers may rely on the regulations for bonds issued after December 21, 1992. (However, under amendments (issued February 28, 1991) to the 1986 proposed regulations, a portion of the bond's issue price was allocable to the conversion feature if the conversion feature could have been satisfied in cash. This amendment was modified by further proposed regulations (issued December 22, 1992) and is not mentioned in the final regulations (adopted January 27, 1994)).

Bonds that are convertible into stock or a debt instrument of a corporation *other than the issuer* are valued under the noncontingent bond method.[5] This method provides for a projected payment schedule consisting of all noncontingent payments and a projected amount for each contingent payment.[6] Except in the case of a contingent payment that is fixed more than six months before it is due, the projected payment schedule generally remains fixed throughout the term of the debt instrument and any income, deductions, gain, or loss attributable to the

1. Rev. Rul. 72-265, 1972-2 CB 222.
2. Rev. Rul. 69-135, 1969-1 CB 198.
3. See Treas. Regs. §§1.1232-3(b)(2)(i); 1.1273-2(j).
4. Treas. Reg. §1.1273-2(j).
5. Treas. Reg. §1.1275-4(b)(1).
6. Treas. Reg. §1.1275-4(b)(2).

debt instrument is based on this schedule.[1] (Proposed regulations formerly provided for valuing the bond and conversion feature separately and allocating the issue price to the separate components). The Service has ruled that the noncontingent bond method applied to a debt instrument that was convertible into stock of the issuer and that also provided for one or more contingent cash payments.[2]

Inflation-Indexed Bonds

7626. What are Treasury Inflation-Protection Securities?

Treasury Inflation-Protection Securities (TIPS) are obligations of the federal government, the principal value of which is adjusted for inflation and deflation based on monthly changes in the nonseasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U). Treasury Inflation-Protection Securities are issued in minimum denominations of $100 with $100 increments thereafter. They provide for semiannual payments of interest and a payment of principal at maturity. The interest rate of Treasury Inflation-Protection Securities is fixed, although the amount of each interest payment will vary with changes in the value of the principal of the security as adjusted for inflation and deflation. Each semiannual interest payment is determined by multiplying the single fixed rate of interest by the inflation-adjusted principal amount (determined as explained below) of the security for the date of the interest payment.[3]

The inflation-adjusted principal amount of the security for the first day of any month is an amount equal to the principal amount at issuance multiplied by a ratio, the numerator of which is the value of the index for the adjustment date and the denominator of which is the value of the index for the issue date. The inflation-adjusted principal amount of the security for a day other than the first day of a month will be determined based on a straight-line interpolation between the inflation-adjusted principal amount for the first day of the month and the inflation-adjusted principal amount for the first day of the next month. The value of the index used to determine the adjustment for the first day of a particular month will be the value of the index reported for the third preceding month.[4]

A Treasury Inflation-Protection Security also provides for an additional payment at maturity if the security's inflation-adjusted principal amount for the maturity date is less than the security's principal amount at issuance. The additional amount payable will equal the excess of the security's principal amount at issuance over the security's inflation-adjusted principal amount for the maturity date.[5] This type of payment is referred to in regulations (see Q 7627) as a *minimum guarantee payment*.

Treasury Inflation-Protection Securities were first issued in January 1997 and are currently available in the form of 5-year, 10-year, and 30-year inflation-indexed notes. The Treasury

1. Treas. Reg. §1.1275-4(b).
2. See Rev. Rul. 2002-42, 2002-2 CB 76.
3. Notice 96-51, 1996-2 CB 216.
4. Notice 96-51, above.
5. Notice 96-51, above.

Department is authorized to offer notes with maturities as short as one year.[1] Treasury Inflation Protection Securities (TIPS) are auctioned as follows: 5-year TIPS in April, with reopenings in October; 10-year TIPS in January and July, with reopenings in April and October; and 30-year TIPS in February, with reopenings in August.

Treasury Inflation-Protection Securities are taxed under the general rules applicable to inflation-indexed bonds (see Q 7627).

For the treatment of inflation-indexed *savings* bonds, see Q 7670.

7627. How are inflation-indexed bonds treated for tax purposes?

A bond is considered inflation-indexed for federal income tax purposes if: (1) it was issued for U.S. dollars and all payments on the instrument are denominated in U.S. dollars; (2) each payment on the debt instrument is indexed for inflation and deflation except for a *minimum guarantee payment* (defined below); and (3) no payment on the debt instrument is subject to a contingency other than the inflation contingency, a minimum guarantee payment, or certain inflation-indexed payments under one or more alternative schedules.[2] A minimum guarantee payment is an additional payment that is made at maturity if the total amount of the inflation-adjusted principal paid on the bond is less than the bond's stated principal amount.[3]

Holders and issuers of inflation-indexed debt instruments, including Treasury Inflation-Protection Securities (see Q 7626), are required to account for interest and original issue discount (inflation adjustments) with constant yield principles using either the coupon or discount bond methods described below.

Coupon Bond Method

The coupon bond method is a simplified version of the discount method (see below) that will apply if two conditions are satisfied: (1) the bond must be issued at par; and (2) all stated interest must be *qualified stated interest*.[4] A bond is issued at par if there is less than a de minimis difference between the bond's issue price and its principal amount at issuance.[5] An amount is de minimis if it is equal to .0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date.[6] *Qualified stated interest* is stated interest that is unconditionally payable in cash, or is constructively received at least annually at a fixed rate.[7] Any qualified stated interest is taken into account under the taxpayer's regular method of accounting.[8] Because Treasury Inflation-Protection Securities that are not stripped satisfy both of the above conditions, the coupon bond method applies to such securities.[9]

1. See 31 U.S.C. §3103(a).
2. Treas. Reg. §1.1275-7(c); see Notice 96-51, 1996-2 CB 216.
3. Treas. Reg. §1.1275-7(c)(5).
4. Treas. Reg. §1.1275-7(d)(2).
5. Treas. Reg. §1.1275-7(d)(2)(i).
6. Treas. Reg. §1.1273-1(d).
7. Treas. Reg. §1.1275-7(d)(2)(ii).
8. Treas. Reg. §1.1275-7(d)(3).
9. Treas. Reg. §1.1275-7(d)(2).

Under the coupon bond method, an inflation adjustment is taken into account for each taxable year in which the bond is outstanding in an amount equal to the sum of the inflation-adjusted principal amount at the end of the period and the principal payments made during the period minus the inflation-adjusted principal amount at the beginning of the period. A positive inflation adjustment will result in original issue discount while a negative inflation adjustment will be accounted for under the deflation adjustment rules (see below).[1]

Discount Bond Method

An inflation-indexed bond that does not qualify for the coupon bond method (e.g., it is issued at a discount) is subject to the more complex discount bond method. In general, the discount bond method requires holders and issuers to make current adjustments to their original issue discount accruals for inflation and deflation. A taxpayer determines the amount of original issue discount allocable to an accrual period using steps similar to those for original issue discount bonds that are not inflation-indexed (see Q 7635).[2] First, the taxpayer determines the yield to maturity of the debt instrument as if there were no inflation or deflation over the term of the instrument. Second, the taxpayer determines the length of the accrual period, provided that accrual period is no longer than one month. Third, the percentage change in the reference index during the accrual period is determined by comparing the value at the beginning of the period to the value at the end of the period.[3] Fourth, the taxpayer determines the original issue discount allocable to the accrual period and, fifth, allocates a ratable portion of the original issue discount for the accrual period to each day in the period.[4]

Holders of stripped Treasury Inflation-Protection Securities must use the discount bond method to account for the original issue discount on the principal and coupon components of the bond.[5]

Deflation Adjustments

Under the coupon and discount bond methods, a deflation adjustment reduces the amount of interest otherwise includable in a bondholder's income with respect to the bond for the taxable year. "Interest," for this purpose, includes original issue discount, qualified stated interest, and market discount.[6] If the amount of the deflation adjustment exceeds the amount of interest otherwise includable in income by the holder for the taxable year with respect to the bond, the excess is treated as an ordinary loss for the taxable year. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the bond in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the bond in prior taxable years. If the deflation adjustment exceeds the interest otherwise includable in income by the holder with respect to the bond for the taxable year and the amount treated as an ordinary loss for the taxable year, this excess is carried forward

1. Treas. Reg. §1.1275-7(d)(4).
2. See Treas. Reg. §1.1272-1(b)(1).
3. See Treas. Reg. §1.1275-7(e)(3)(iii).
4. Treas. Regs. §§1.1275-7(e)(3)(iv) and 1.1275-7(e)(3)(v).
5. Treas. Reg. §1.1286-2.
6. Treas. Reg. §1.1275-7(f)(1).

to reduce the amount of interest otherwise includable in income with respect to the bond for subsequent taxable years.[1]

Miscellaneous Rules

If a bond features a minimum guarantee payment, the payment is treated as interest on the date it is paid. However, under both the coupon and discount bond methods, the minimum guarantee payment is ignored until such a payment is made.[2]

A subsequent holder determines the amount of acquisition premium or market discount by reference to the adjusted issue price of the instrument on the date the holder acquires the instrument. The amount of bond premium is determined by assuming the amount payable at maturity on the instrument is equal to the instrument's inflation-adjusted principal amount for the day the holder acquires the instrument. Furthermore, any premium or market discount is taken into account over the remaining term of the bond as if there were no further inflation or deflation.[3] For the treatment of market discount bonds, see Q 7628 to Q 7634. The treatment of bond premium is explained in Q 7639 to Q 7641.

A bondholder's adjusted basis is determined under the rules for original issue discount bonds that are not inflation-indexed (see Q 7635).[4] However, the adjusted basis is decreased by the amount of any deflation adjustment the bondholder takes into account to reduce the amount of interest otherwise includable in income or treats as an ordinary loss with respect to the bond during the taxable year.[5]

In the event of the temporary unavailability of a qualified inflation index, special rules apply.[6]

Special rules apply in determining bond premium on inflation-indexed bonds.[7] Bond premium is explained in Q 7639 to Q 7640.

For the treatment of qualified tuition programs, see Q 595. For the treatment of inflation-indexed *savings* bonds, see Q 7670.

Market Discount

7628. What is market discount? What is a "market discount bond"?

Bond prices on the market fluctuate as interest rates change and as the borrower's credit rating changes. Therefore, bonds may be bought at a discount because of a decline in value of the obligation after issue. A bond acquired at a discount on the market is called a "market discount bond." For tax purposes the term "market discount bond" does not include tax-exempt municipal obligations purchased before May 1, 1993, short-term obligations, and U.S. Savings

1. Treas. Reg. §1.1275-7(f)(1)(i).
2. Treas. Reg. §1.1275-7(f)(4).
3. Treas. Reg. §1.1275-7(f)(3).
4. See Treas. Reg. §1.1272-1(g).
5. Treas. Reg. §1.1275-7(f)(2).
6. See Treas. Reg. §1.1275-7(f)(5).
7. See Treas. Reg. §1.171-3(b).

Bonds.[1] With certain exceptions (e.g., bonds acquired at issue for less than issue price–usually by large institutional investors), bonds acquired at the time of original issue are not "market discount" bonds.[2]

Market discount is the amount by which the stated redemption price exceeds the taxpayer's basis in the bond immediately after its acquisition, if the bond was originally issued at par.[3] If the bond was originally issued at a discount and purchased on the market for less than the original issue price increased by the amount of original issue discount accruing since issue up to the date of purchase, the difference is market discount.[4] If the total market discount is less than ¼ of 1 percent (.0025) of the stated redemption price at maturity (or if the bond was issued at a discount of the issue price increased by original issue discount accruing since issue to the date of purchase) multiplied by the number of complete years until maturity, it is treated as if there were no market discount.[5]

7629. Is market discount on a taxable bond included annually in gross income as it accrues?

As a rule, market discount is not includable in income by a cash basis investor before sale or disposition of the bond or note. However, an election may be made to include market discount as it accrues on bonds and notes other than tax-exempt obligations purchased before May 1, 1993, short-term obligations, U.S. Savings Bonds, and certain obligations arising from installment sales of property.[6] (Such an election may be necessary to permit current deduction of interest paid on amounts borrowed to acquire bonds issued after July 18, 1984, or issued on or before July 18, 1984, and purchased on the market after April 30, 1993 (see Q 7945). Once the election is made, it applies to *all* obligations having market discount (other than tax-exempt obligations purchased before May 1, 1993, short-term obligations, certain obligations arising from installment sales of property, and U.S. Savings Bonds) *acquired* by the taxpayer in the tax year of the election and any future years (whether or not using borrowed funds) unless the taxpayer receives permission from the IRS to revoke the election.[7] Amounts includable under the election are treated as interest (except for purposes of the tax on non-business income of nonresident aliens and foreign corporations and, apparently, for withholding generally). Thus, for example, includable market discount is counted as investment income for purposes of determining the limit on deductible interest expense (see Q 7941).

Any partial payment of principal on a market discount bond acquired after October 22, 1986, is includable as ordinary income to the extent it does not exceed the market discount on the bond that has accrued up to that time. The amount of accrued market discount is reduced accordingly (see Q 7630).[8] If the principal of a bond acquired after October 22, 1986, is to be

1. IRC Sec. 1278(a)(1).
2. IRC Sec. 1278(a)(1)(D).
3. IRC Sec. 1278(a)(2).
4. IRC Sec. 1278(a)(2)(B).
5. IRC Sec. 1278(a)(2)(C).
6. IRC Sec. 1278(b).
7. IRC Sec. 1278(b)(3).
8. IRC Sec. 1276(a)(3).

paid in two or more payments, the amount of accrued market discount is to be determined under regulations.[1]

Under the election to include market discount in income as it accrues, market discount is accrued on a ratable basis, but the taxpayer may instead elect to use a constant interest rate with respect to particular bonds and notes. Under the ratable accrual method, the amount of market discount is determined by dividing the total market discount on the bond by the number of days after the date of acquisition (up to and including the date of maturity). This method will accrue market discount in equal daily installments during the period between acquisition and maturity. Alternatively, the taxpayer may elect to accrue market discount on a constant interest rate method (the method used in determining daily portions of original issue discount on bonds issued after July 1, 1982 (see Q 7635). The constant interest rate election is irrevocable as to the bond for which the election is made, but the ratable method will apply to other obligations for which the constant interest rate election was not made.[2]

The Service has established procedures for taxpayers to use in making the elections described above. Specific procedures are required to be followed under the following circumstances: (1) the taxpayer wishes to make an election under IRC Section 1278(b) for a taxable year ending after July 18, 1984, and his or her income tax return is filed (on time) on or after September 23, 1992; (2) the taxpayer wishes to make an election under IRC Section 1276(b) to apply a constant interest rate to a market discount bond acquired in a taxable year ending after July 18, 1984, and his or her income tax return is filed (on time) on or after September 23, 1992; or (3) the taxpayer wishes to request consent to revoke an election under IRC Section 1278(b). If the procedures detailed by the Service are followed with respect to elections made under IRC Sections 1278(b) and 1276(b), the Service's consent to such elections will be automatic.[3]

The taxpayer who elects to include market discount as it accrues increases basis by the amounts included in gross income each year.[4]

The rules applicable to market discount on tax-exempt municipal bonds are discussed in Q 7645.

7630. How is gain or loss treated when a market discount bond is sold?

When a cash basis taxpayer sells a market discount bond (as defined in Q 7628) issued after July 18, 1984, or issued on or before July 18, 1984, and purchased after April 30, 1993, or if the taxpayer sells a tax-exempt bond purchased on the market after April 30, 1993, at a discount, the gain is generally treated as interest income to the extent of market discount accrued up to the date of disposition.[5] Only gain in excess of the amount of accrued market discount may be treated as capital gain. (See Q 608 for the treatment of capital gains and losses). However, if the

1. IRC Sec. 1276(b)(3).
2. IRC Sec. 1276(b)(2).
3. Rev. Proc. 92-67, 1992-2 CB 429; *as modified by* Rev. Proc. 99-49, 1999-2 CB 725; *modified, amplified, and superseded by* Rev. Proc. 2002-9, 2002-1 CB 327; Rev. Proc. 2008-52, 2008-2 CB 587, as modified by Rev. Proc. 2013-20, 2013-1 CB 744.
4. IRC Sec. 1278(b)(4).
5. IRC Secs. 1276, 1278.

taxpayer elected to include market discount in income annually as it accrued, and to increase the basis, the gain would not include previously included market discount.[1] The rule reflects recognition that market discount is a substitute for stated interest.

In determining how much market discount has accrued up to the time of sale, the discount is treated as accruing in equal amounts each day after the date of acquisition up to and including the date of maturity. But the taxpayer may elect (irrevocably) on a bond by bond basis to accrue using a constant rate of interest compounded at least annually as used in determining daily portions of original issue discount accruing on bonds issued after December 31, 1984 (see Q 7635).[2] Under the constant rate method, the daily portions will accrue more slowly than under the ratable method in early years and more rapidly in later years, but the total amount accrued will always be less until maturity.

An adjustment must be made in determining the amount of accrued market discount on obligations issued after October 22, 1986, if a partial payment of principal was previously made, or if principal is paid in two or more payments (see Q 7629).

Gain treated as interest income will generally be treated as interest for all purposes of federal taxation. Thus, for example, it is investment income for purposes of the limitation on the deduction of interest expense (see Q 7941). However, accrued market discount will presumably not be treated as interest for withholding purposes.[3]

For taxable bonds issued on or before July 18, 1984, and acquired on the market after that date but before May 1, 1993, and for tax-exempt bonds purchased on the market before May 1, 1993, recovery of market discount on sale or disposition is generally treated as capital gain, rather than as interest income. However, gain on such *taxable* bonds acquired with borrowing (or the proceeds of a short sale) must be recognized as ordinary income to the extent of any deferred disallowed interest (or short sale) expense (discussed in Q 7945) that is deductible in the year of disposition.[4]

Loss on sale or disposition of a market discount bond is a capital loss (see Q 608).[5] For the rules governing the treatment of market discount when there is a substitution of newly issued bonds for outstanding bonds, see Rev. Proc. 2001-21.[6]

The installment method for reporting gain is not available for securities traded on an established securities market (see Q 586). As a result, gain from sale is included in income for the year in which the trade date occurs even if one or more payments are received in a subsequent tax year.[7]

If the disposition is by gift, see Q 7631; by conversion of a convertible bond into stock, see Q 7624 and Q 7633. If the bond sold was acquired by gift, see Q 7632.

1. IRC Sec. 1278(b).
2. IRC Sec. 1276(b)(2).
3. General Explanation–TRA '84, p. 94.
4. IRC Sec. 1277(d), prior to repeal by OBRA '93.
5. Rev. Rul. 60-210, 1960-1 CB 38.
6. 2001-1 CB 742.
7. IRC Sec. 453(k). See Rev. Rul. 93-84, 1993-2 CB 225.

If a market discount bond was held as part of a tax straddle, the additional rules and qualifications explained in Q 7587 to Q 7603 apply. If a market discount bond was held as part of a conversion transaction, the additional rules discussed in Q 7604 and Q 7605 apply.

Generally, neither gain nor loss is recognized on a transfer between spouses, or between former spouses if incident to divorce (see Q 660).[1]

7631. Does a donor include accrued market discount in income when he or she makes a gift of a market discount bond?

When a taxpayer makes a gift of a taxable bond issued after July 18, 1984, or a taxable bond issued on or before July 18, 1984, and purchased after April 30, 1993, or a tax-exempt bond purchased after April 30, 1993, any of which the taxpayer acquired at a market discount and that has appreciated in value at the time of the gift, he or she must include in gross income an amount equal to the market discount accrued to the date of the gift, but limited to the amount of gain that would have been realized had the taxpayer received fair market value on making the gift.[2] The amount is treated as interest income (but not for withholding at the source).[3] Discount is considered to have accrued on a ratable basis, or, if the taxpayer elects (irrevocably), at a constant interest rate, just as if he or she had sold the bond (see Q 7630). Had the taxpayer previously elected to include market discount in gross income as it accrued (see Q 7629), no accrued discount would be includable as a result of the gift.[4]

If a bond was issued on or before July 18, 1984, and purchased before May 1, 1993, or if the bond is a tax-exempt issue purchased before May 1, 1993, no accrued market discount is included in income.[5]

7632. How is market discount treated on sale of a market discount bond received as a gift?

If gain is realized by a donee on disposition of a taxable bond issued after July 18, 1984, or a taxable bond issued on or before July 18, 1984, and purchased after April 30, 1993, or a tax-exempt bond purchased after April 30, 1993, any of which were previously received as a gift but acquired at a market discount by the donor, the gain is reported as interest up to the amount of market discount accrued prior to the time of sale and not previously included in income by the donor or donee (see Q 7630).[6] An adjustment to basis is made for any amount of accrued market discount recognized by the donor at the time of the gift and for any market discount included in the gross income of the donor and donee as it accrued.[7]

If the donor used borrowed funds (or the proceeds of a short sale) to acquire or carry a *taxable* bond described above, and as a result there was disallowed interest expense (or short sale

1. IRC Sec. 1041.
2. IRC Sec. 1276.
3. General Explanation–TRA '84, p. 94.
4. IRC Sec. 1278(b).
5. TRA '84, Sec. 44(c)(1). See IRC Secs. 1276, 1277, and 1278.
6. IRC Sec. 1276(c).
7. IRC Secs. 1276(c), 1278(b).

expense) with respect to the bond at the time of the gift that was not entirely deductible by the donor at the time the donor made the gift, the donee may take the excess disallowed expense deduction as the donee's own when he or she sells the bond (see Q 7945).[1]

Even if the taxable bond was issued on or before July 18, 1984, but acquired by the donor before May 1, 1993, the donee may deduct the disallowed expense.[2] However, if there is a gain on the sale of such a bond, the donee must treat an amount equal to the interest (or short sale) expense deduction as ordinary income instead of capital gain (see Q 7945). [3]

7633. How is market discount treated on the sale of stock received on conversion of a market discount bond?

If, on conversion of a market discount bond issued after July 18, 1984, or issued on or before July 18, 1984, and purchased after April 30, 1993, a taxpayer receives stock in the issuer of the bond, the amount of market discount accrued to the date of exchange must be treated as ordinary interest income upon sale or disposition of the stock, unless the taxpayer had elected to include in income market discount on the bond as it accrued.[4]

7634. Are interest expenses deductible if market discount bonds are purchased or carried with borrowed funds?

If interest is paid on borrowing or is incurred or continued by the taxpayer in order to purchase or carry *taxable* market discount bonds, deduction of the interest expense may be subject to limitation and deferral.[5] Certain short sale expenses (see Q 7529, Q 7530) may be treated as interest within this rule.[6] See Q 7945 for details. Any amount deductible under these rules will also be subject to the general limit on the otherwise allowable deduction of investment interest (see Q 7941).

Original Issue Discount

7635. How is original issue discount on corporate and Treasury obligations issued after July 1, 1982, included in income?

If a bond is originally issued at a price that is less than its stated redemption price at maturity, the difference is original issue discount (OID). However, if the discount at which a bond was issued is less than ¼ of 1 percent (.0025) of the stated redemption price multiplied by the number of complete years to maturity, the bond is treated (for tax purposes) as if it were issued without a discount.[7]

If a bond is issued for property (stock or securities, or to the extent provided for in regulations, for other property in tax years ending after July 18, 1984) and either the bond or the

1. IRC Secs. 1277(b)(2)(B), 1278(a)(1)(C).
2. IRC Sec. 1277(b)(2).
3. IRC Sec. 1277(d), prior to repeal by OBRA '93.
4. IRC Secs. 1276(c), 1278(b).
5. IRC Secs. 1277(a), 1278(a)(1)(C).
6. IRC Sec. 1282(c). See General Explanation–TRA '84, p. 98.
7. IRC Sec. 1273(a).

property is traded on an established market, the issue price of the bond is considered to be the fair market value of the property.[1]

The amount of original issue discount is included in income as it accrues over the life of the bond. For bonds issued after April 4, 1994, OID must generally be accrued using the constant yield method. The holder of a bond may use accrual periods of different lengths provided that no accrual period is longer than one year. Payments may occur either on the first day or final day of an accrual period.[2]

The amount of original issue discount accruing each period is ratably allocated to each day in the period. These "daily portions" must be included in gross income by each owner for each day the owner holds the bond during the tax year.[3] (More often than not, the individual's tax year will overlap two periods. If so, the owner simply totals the appropriate daily portions for the parts of each period that falls in his or her tax year). Taxpayers who use the cash receipts and disbursement method of accounting and maintain a brokerage account that includes original issue discount debt instruments and stripped bonds must include in gross income for the taxable year the amount of accrued discount allocable to the portion of the taxable year in which they held the debt instruments. The taxpayers cannot defer the inclusion of original issue discount until it is actually received.[4]

Gain on the sale, exchange, or retirement of a bond is treated as ordinary income to the extent of unaccrued original issue discount if, at the time of original issue, there existed an intention to call the bond prior to maturity. According to regulations, an intention to call exists only if there is an agreement not provided for in the debt instrument that the issuer will redeem the instrument prior to maturity.[5] This rule is not applicable to publicly offered bonds.[6] The rules of this paragraph are effective for bonds issued on or after April 4, 1994, and may be relied upon by taxpayers with bonds issued after December 21, 1992.

If the holder purchased the debt instrument at a premium or an acquisition premium or made an election to treat all interest as original interest discount, the amount of original issue discount must be adjusted.[7] Furthermore, for bonds held on or after March 2, 1998, a holder making an election to treat all interest on a bond as original issue discount is deemed to have elected to amortize any existing bond premium (see Q 7639).[8]

The owner's basis is increased by the amount of discount included in income and decreased by the amount of any payment from the issuer to the holder under the debt instrument other than a payment of qualified stated interest.[9]

1. IRC Sec. 1273(b)(3).
2. Treas. Reg. §1.1272-1(b)(1).
3. IRC Sec. 1272(a)(1).
4. *Gaffney v. Comm.*, TC Memo 1997-249.
5. Treas. Reg. §1.1271-1(a)(1).
6. Treas. Reg. §1.1271-1(a)(2)(i).
7. Treas. Reg. §1.1272-1(b)(3).
8. Treas. Reg. §1.171-4(a)(2).
9. IRC Sec. 1272(d)(2); Treas. Reg. §1.1272-1(g).

The application of these rules to bonds acquired in a debt-for-debt exchange in a corporate reorganization is covered in Treasury Regulation Section 1.1272-2.

The Service ruled that a taxpayer who acquired two debt instruments that were structured so that it was expected that the value of one would increase significantly at the same time that the value of the other debt instrument would decrease significantly was not allowed to claim a current loss on the sale of the debt instrument that decreased in value while not recognizing the gain on the other debt instrument. The loss deductions for each set of debt instruments were denied under IRC Section 165(a) and Treasury Regulation Sections 1.1275-6(c)(2) (the integration rule) and 1.1275-2(g) (the anti-abuse rule), respectively.[1]

Special rules apply to determine the inclusion in income of original issue discount on debt instruments issued after 1986 that have a maturity that is initially fixed, but that is accelerated based on prepayments on other debt obligations securing the debt instrument.[2] For rules applying to variable rate debt instruments and debt instruments that provide for contingent payments, see Treasury Regulation Section 1.1272-1(b)(2). The sale of additional Treasury or corporate debt instruments that are issued after the original issue but that are treated as part of the original issue is referred to as a "qualified reopening." For rules governing the treatment of original issue discount with respect to such sales, see Treasury Regulation Sections 1.163-7(e), 1.1275-1(f), 1.1275-2(d); 1.1275-2(k), 1.1275-7(g). See also Revenue Procedure 2001-21[3] (providing an election that will facilitate the substitution of newly issued bonds for outstanding bonds).

These rules do not apply to tax-exempt bonds, to short-term government (federal or state) obligations (such as T-bills), to savings bonds (e.g., EE bonds), or to short-term corporate obligations.[4]

The treatment of Treasury bills is discussed in Q 7612 and Q 7613, and short-term corporate obligations in Q 7614 and Q 7615.

7636. How is original issue discount treated in the case of Treasury notes and bonds issued before July 2, 1982, and after December 31, 1954?

Any original issue discount on Treasury notes and bonds issued between January 1, 1955, and July 1, 1982 (inclusive), is not included in income until the bond is sold or redeemed.[5] (If the discount at issue was less than ¼ of 1 percent (.0025) of the stated redemption price, multiplied by the number of full years from the date of original issue to maturity, the bond is not considered issued at a discount).[6]

If the owner purchased the bond at a premium (i.e., at a price above the stated redemption price), no original issue discount is included in income on the sale or maturity of the obligation.[7]

1. Rev. Rul. 2000-12, 2000-1 CB 744.
2. See IRC Sec. 1272(a)(6).
3. 2001-1 CB 742.
4. IRC Sec. 1272(a).
5. IRC Sec. 1271(c)(2).
6. IRC Sec. 1273(a)(3).
7. IRC Sec. 1271(a)(2)(B). See Treas. Reg. §1.1232-3(d). See also Treas. Reg. §1.1272-2.

If the obligation is sold or redeemed by a seller who did not buy at a premium and *gain* is realized, a part of the proceeds must be treated by the seller as ordinary income attributable to the original issue discount. The amount of discount treated as ordinary income is based on the proportionate part of the time from issue to the date of maturity that the seller held the obligation, and it is computed by multiplying the original issue discount by a fraction having as numerator the number of full months the obligation was held by the seller and as denominator the number of full months from the date of original issue to the stated date of maturity.[1] Any days amounting to less than a full month are not counted.[2]

In determining how many months the seller held the obligation, he or she must include any period it was held by another person if the seller's tax basis for determining gain or loss is the same, in whole or in part, as it would be in the hands of the other person.[3]

U.S. Savings Bonds are discussed at Q 7660 to Q 7669. Treasury Bills are discussed in Q 7612 and Q 7613.

7637. How is original issue discount on corporate bonds treated if issued before July 2, 1982 and after May 27, 1969?

A prorated part of the original issue discount is included in income as interest each year, even though it is not actually received, unless the owner paid a premium (i.e., more than the stated redemption price) when the bond was purchased, or the obligation matured in one year or less. The amount is determined as follows:

By the original owner. The original issue discount is divided by the number of complete months plus any fractional part of a month (as explained below) from the date of original issue through the day before the stated maturity date. (This is called the "ratable monthly portion").[4] The ratable monthly portion is multiplied by the number of complete months plus any fractional part of a month the taxpayer held the bond during the year.[5]

By a subsequent owner. Like the original owner, a subsequent owner includes in income each year a "ratable monthly portion" of original issue discount multiplied by the number of months plus fractional parts of a month the subsequent owner held the bond. However, he or she may determine the ratable monthly portion in a different way if it results in a lower amount. Instead of dividing the original issue discount by the term of the bond, the subsequent owner may divide the amount by which the bond's stated redemption price at maturity exceeds the bond's cost to him or her by the number of complete months plus any fractional part of a month beginning on the day of purchase of the obligation and ending on the day before the stated maturity date of the obligation.[6] An individual is not considered to have "purchased" the bond if the bond's basis is determined, in whole or in part, by reference to the basis of the obligation in the hands of the person from whom it was acquired, or by reference to the estate tax valuation.[7]

1. IRC Sec. 1271(c).
2. See Treas. Reg. §1.1232-3(c), Ex.(1).
3. Treas. Reg. §1.1232-3(c).
4. Treas. Reg. §1.1232-3A(a)(2)(i); IRC Sec. 1272(b)(2).
5. IRC Sec. 1272(b)(1); Treas. Reg. §1.1232-3A(a)(1).
6. IRC Sec. 1272(b)(4); Treas. Regs. §§1.1232-3A(a)(2)(ii), 1.1232-3A(a)(3)(i).
7. IRC Sec. 1272(d); Treas. Reg. §1.1232-3A(a)(4).

Thus, if the amount paid by the subsequent owner is not more than the original issue price plus all amounts of original issue discount previously includable (whether or not included) in income by previous holders, his or her ratable monthly portion of the original issue discount is calculated like the original holder's. But, if the subsequent owner paid more than the original issue price plus the amount of original issue discount includable in the income of any previous holder, he or she may reduce the original issue discount remaining by the excess amount before determining the monthly portion. This excess amount is called an "acquisition premium." (In computing the amount of original issue discount includable by previous holders, one does not take into consideration any acquisition premium paid by previous holders or that a holder may, in fact, have purchased at a premium).[1]

For either an original or subsequent holder, a complete or fractional month begins with the date of original issue and the corresponding day of each following calendar month (or the last day of a calendar month in which there is no corresponding day). If a holder sells the bond on any other day in the month, a part of the ratable monthly portion for that month is allocated between the seller and buyer based on the number of days in the month each held the bond. (Seller and buyer may allocate on the basis of a 30-day month). The transferee is deemed to hold the obligations the entire day of acquisition, but not on the day of redemption.[2]

The original or any subsequent holder increases the holder's basis by amounts of includable original issue discount actually included in income.[3]

7638. How is original issue discount on corporate bonds issued before May 28, 1969 and after December 31, 1954 taxed?

Original issue discount is included in income in the same manner as Treasury securities issued before July 2, 1982 (see Q 7636).[4]

However, if at the time of original issue there was an intention to call the obligation before maturity, the gain up to the entire original issue discount is treated as ordinary income.[5]

There was an intention to call before maturity if there was an understanding between the issuing corporation and the original purchaser that the issuer would redeem the obligation before maturity. The understanding need not have been communicated directly to the purchaser by the issuer and the understanding may have been conditional (e.g., it may have been dependent on the issuer's financial condition on the proposed call date). Whether there was an understanding depends on all the facts and circumstances. That the obligation on its face gave the issuer the privilege of redeeming the obligation before maturity is not determinative of an intention, and if the obligation was part of an issue registered with the SEC and sold to the public without representation that the obligor intended to call, it is presumed that there was no intention at issue to call.[6]

1. IRC Sec. 1272(b); Treas. Reg. §1.1232-3A(a)(2)(ii).
2. Treas. Reg. §1.1232-3A(a)(3).
3. IRC Sec. 1272(d)(2); Treas. Reg. §1.1232-3A(c).
4. IRC Sec. 1271(c)(2).
5. IRC Sec. 1271(c).
6. See Treas. Reg. §1.1232-3(b)(4).

Bond Premium

7639. Must premium paid on taxable bonds be amortized annually? Must basis be reduced by the amount of amortizable premium?

An individual who purchased a taxable bond at a premium (that is, at an amount in excess of its face value), whether or not on original issue, may *elect* to amortize the premium over the remaining life of the bond (or in some cases, until an earlier call date).[1] If the election to amortize bond premium is not made, the premium is recovered as part of the owner's basis in the bond, if the bond is sold for as much as or more than its cost, or is deducted as a capital loss if the bond is redeemed at face value or sold for less than the basis. See Q 7640 for an explanation of how the amount of amortizable bond premium is determined.

The election to amortize applies to all taxable bonds that are owned at the beginning of the first year to which the election applies and all bonds acquired thereafter, and may be revoked only with the consent of the Service.[2] Under regulations generally in effect for bonds acquired on or after March 2, 1998, a revocation of the election applies to all taxable bonds held during or after the taxable year for which the revocation is effective, and the holder may not amortize any remaining bond premium on bonds held at the beginning of the taxable year for which the revocation is effective.[3] See below for the effective date of the regulations.

The term "bond" to which the election applies includes any taxable bond, debenture, certificate, or other evidence of indebtedness issued by any corporation, government, or political subdivision.[4] The taxpayer is not required to amortize premium on taxable bonds just because the taxpayer has *tax-exempt* bonds that he or she is amortizing.

For bonds acquired after December 31, 1987, an electing taxpayer applies the part of the premium attributable to the year as an offset to interest payments (that is, in direct reduction of interest income) received on the bond to which the premium is attributable.[5]

Taxpayers who elected to amortize premium on bonds acquired after October 22, 1986, and before January 1, 1988, could elect to use either the deduction or the offset method.[6] These taxpayers treat the deduction as investment interest expense subject to the investment interest deduction limitations.[7]

With respect to bonds acquired before October 23, 1986, a taxpayer who elected to amortize takes an annual itemized interest expense deduction.[8] The deduction is not subject to the 2 percent floor on miscellaneous deductions.[9] Such an election to amortize in effect on October 22, 1986, does not apply to bonds acquired after October 22, 1986, unless the taxpayer so elected.[10]

1. IRC Sec. 171.
2. IRC Sec. 171(c)(2); Treas. Reg. §1.171-4.
3. Treas. Reg. §1.171-4(d).
4. IRC Sec. 171(d).
5. IRC Sec. 171(e).
6. TAMRA '88, Sec. 1803(a)(11)(B).
7. IRC Sec. 171(e), as in effect prior to amendment by TAMRA '88, Sec. 1006(j)(1).
8. IRC Sec. 171(a).
9. IRC Sec. 67(b)(11); see Conf. Report 99-841, Vol. II at page 34, 1986-3 CB Vol. 4.
10. TAMRA '88, Act Sec. 1006(j)(2).

Under regulations generally in effect for bonds acquired on or after March 2, 1998, a holder makes the election to amortize by offsetting interest income with bond premium in the holder's timely filed federal income tax return for the first taxable year to which the holder desires the election to apply. A holder should also attach a statement to the return that he or she is making the election. See below for the effective date of the regulations. Regulations reflecting the law in effect prior to October 23, 1986, provided that the election was made by deducting the premium attributable to the year as an interest expense for the first year to which the election was to apply. The election to amortize could not be made in a refund claim.[1]

A bondholder making an election to treat all interest on a bond as original issue discount is deemed to have elected to amortize any existing bond premium (see Q 7635).[2]

If a bondholder elects to amortize bond premium and holds a taxable bond acquired before the taxable year for which the election is made, the holder may not amortize amounts that would have been amortized in prior taxable years had an election been in effect for those prior years.[3]

A taxpayer electing to amortize must also reduce basis in the bond by the amount of premium that is an allowable deduction or that was applied in reduction of interest payments each year.[4]

A bond with interest that is partially excludable from gross income is treated as two instruments, a tax-exempt obligation and a taxable bond. The holder's bases in the bond and each payment on the bond are allocated between the two instruments based on a reasonable method.[5] See Q 7646 and Q 7647 regarding the amortization of premium on tax-exempt bonds.

Regulations provide special rules that apply to certain variable rate debt instruments, bonds subject to certain contingencies, and inflation-indexed debt instruments.[6]

The regulations under IRC Section 171 do not apply to (1) a bond described in IRC Section 1272(a)(6)(C) (relating to regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration); (2) a bond to which Treasury Regulation Section 1.1275-4 applies (relating to certain contingent pay debt instruments); (3) a bond held by a holder that elected to treat all interest on a debt instrument as original issue discount; (4) a bond that is stock in trade of the holder, a bond of a kind that would properly be included in the inventory of the holder if on hand at the close of the taxable year, or a bond held primarily for sale to customers in the ordinary course of the holder's trade or business; or (5) a bond issued before September 28, 1985, unless the bond bears interest and was issued by a corporation or by a government or political subdivision thereof.[7]

1. *Woodward Est. v. Comm.*, 24 TC 883 (1955) *aff'd sub. nom. Barnhill v. Comm.*, 241 F.2d 496 (5th Cir. 1957), *acq.*, 1956-2 CB 4, 1956-2 CB 9.
2. Treas. Reg. §1.171-4(a)(2).
3. Treas. Reg. §1.171-4(c).
4. IRC Sec. 1016(a)(5); Treas. Reg. §1.1016-5(b).
5. Treas. Reg. §1.171-1(c)(3).
6. See Treas. Reg. §1.171-3.
7. Treas. Reg. §1.171-1(b)(2).

Regulations generally in effect for bonds acquired before March 2, 1998 (or held before a taxable year containing March 2, 1998, in which an election to amortize was made) provided that, if in any year an individual who amortizes bond premium by deducting it as an interest expense does not itemize deductions, but takes a standard deduction, the deduction is deemed to have been allowed and reduces basis.[1] Regulations also provided that an individual may, but need not, amortize premium in a year in which no interest is received.[2] The regulations, as amended December 30, 1997, do not include the above rules.

Amortization of premium on tax-exempt bonds is discussed in Q 7646.

Effective date of regulations. The regulations under IRC Section 171 (as amended December 30, 1997) apply to bonds acquired on or after March 2, 1998. However, if a bondholder elected to amortize bond premium for the taxable year containing March 2, 1998, or any subsequent taxable year, the regulations under IRC Section 171 apply to bonds held on or after the first day of the taxable year in which the election was made.[3]

Furthermore, a holder was deemed to have made the election under regulations for the taxable year containing March 2, 1998, if the holder elected to amortize bond premium under IRC Section 171 and that election was effective on March 2, 1998. If the holder was deemed to have made such an election, the regulations under IRC Section 171 apply to bonds acquired on or after the first day of the taxable year containing March 2, 1998.[4]

Substitution of debt instruments. For the revised rules governing the treatment of bond premium when there is a substitution of newly issued bonds for outstanding bonds, see Revenue Procedure 2001-21.[5]

7640. How is the amount of amortizable bond premium determined?

The amortizable premium on taxable bonds acquired on or after January 1, 1958, is the excess of the individual's tax basis for determining *loss* on sale or exchange of the bond (determined at the start of the year) over the amount payable at maturity, or in the case of a callable bond, the earlier call date if using the earlier call date would result in a smaller amortizable amount being allocated to the year.[6] It makes no difference whether the premium is original issue premium or "market" premium (generally reflecting a higher coupon interest rate on the bond than the market interest rate for bonds of similar quality). See Q 7641 in the case of a convertible bond with amortizable bond premium.

Under regulations generally in effect for bonds acquired on or after March 2, 1998, a holder acquires a bond at premium if the holder's basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments of qualified stated interest); the excess is bond premium, which a holder

1. Treas. Reg. §1.171-1(b)(5).
2. Treas. Reg. §1.171-2(e).
3. Treas. Reg. §1.171-5(a).
4. Treas. Reg. §1.171-5(b).
5. 2001-1 CB 742.
6. IRC Sec. 171(b).

amortizes.[1] Bond premium is allocable to an accrual period based on a constant yield that is used to conform the treatment of bond premium to the treatment of original issue discount (see Q 7635).[2] Under a transition rule, the use of a constant yield to amortize premium does not apply to a bond issued before September 28, 1985.[3] See Q 7639 for an explanation of the effective date of the regulations.

In general, the holder's basis in the bond is the holder's basis for purposes of determining loss on the sale or exchange of the bond. This determination of basis applies only for purposes of amortizing premium; a holder's basis in the bond for purposes of amortizing premium may differ from the holder's basis for purposes of determining gain or loss on the sale or exchange of the bond.[4]

For purposes of determining the amount amortizable, if the bond is acquired in an exchange for other property and the bond's basis is determined (in whole or in part) by the basis of the property, the basis of the bond is not more than its fair market value immediately after the exchange.[5] This rule applies to exchanges occurring after May 6, 1986.[6] A special rule applies to a bond acquired in a bond-for-bond exchange in a corporate reorganization.[7]

If the bond is *transferred basis property* and the transferor had acquired the bond at a premium, the holder's basis in the bond is the holder's basis for determining loss on the sale or exchange of the bond reduced by any amounts that the transferor could not have amortized (under the basis rules or because of an election to amortize in a subsequent taxable year), except to the extent that the holder's basis already reflects a reduction attributable to the nonamortizable amounts.[8] *Transferred basis property* is property having a basis determined in whole or in part by the basis of the transferor.[9]

For a detailed explanation of the effective dates for the regulations under IRC Section 171, see Q 7639.

Calculation of Annual Deduction or Offset

Bonds Issued After September 27, 1985

Except as provided in regulations (see below), the determination of the amount of the deduction or offset in any year is computed on the basis of the taxpayer's yield to maturity by using the taxpayer's basis in the bond (for purposes of determining loss) and by compounding at the close of each accrual period. Generally, an accrual period is the same as used in determining original issue discount (see Q 7635). If the amount payable on a call date that is earlier than maturity is used for purposes of determining the yield to maturity, the bond is treated as

1. Treas. Reg. §1.171-1(d).
2. Treas. Reg. §1.171-1(a).
3. Treas. Reg. §1.171-5(a)(2).
4. Treas. Reg. §1.171-1(e).
5. IRC Sec. 171(b)(4); Treas. Reg. §1.171-1(e)(1)(ii).
6. TRA '86, Sec. 1803(a)(12)(A).
7. IRC Sec. 171(b)(4)(B).
8. Treas. Reg. §1.171-1(e)(2).
9. IRC Sec. 7701(a)(43).

maturing on the call date and then as reissued on that call date for the amount payable on the call date.[1] If a taxpayer had an election to amortize bond premium in effect on October 22, 1986, the election applies to bonds issued after September 27, 1985, only if the taxpayer so chooses (as may be prescribed in regulations).[2]

Under regulations generally in effect for bonds acquired on or after March 2, 1998, a holder amortizes bond premium by offsetting the qualified stated interest allocable to an accrual period with the bond premium allocable to the accrual period. This offset occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting.[3] The accrual period to which qualified stated interest is allocable is determined under the regulations to IRC Section 446 (relating to the general rule for methods of accounting).[4] For a detailed explanation of the effective date of the regulations, see Q 7639.

The bond premium allocable to an accrual period is calculated using the following three steps.

Step one: Determine the holder's yield. The holder's yield is the discount rate that, when used in computing the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to the holder's basis in the bond. The remaining payments include only payments to be made after the date the holder acquires the bond. The yield calculated as of the date the holder acquires the bond must be constant over the term of the bond, and must be calculated to at least two decimal places when expressed as a percentage.[5]

Step two: Determine the accrual periods. An accrual period is an interval of time over which the accrual of bond premium is measured. Accrual periods may be of any length over the term of the debt instrument, provided that each accrual period is no longer than one year and each scheduled payment occurs on the final day of an accrual period or on the first day of an accrual period.[6]

Step three: Determine the bond premium allocable to the accrual period. The bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the holder's *adjusted acquisition price* at the beginning of the accrual period and the holder's yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period.[7] The *adjusted acquisition price* of a bond at the beginning of the first accrual period is the holder's basis (see below). Thereafter, the adjusted acquisition price is the holder's basis in the bond decreased by (1) the amount of bond premium previously allocable (as calculated above), and (2) the amount of any payment previously made on the bond other than the payment of qualified stated interest.

1. IRC Sec. 171(b)(3).
2. TRA '86, Sec. 1803(a)(11)(A).
3. Treas. Reg. §1.171-2(a)(1).
4. Treas. Reg. §1.171-2(a)(2).
5. Treas. Reg. §1.171-2(a)(3)(i).
6. Treas. Regs. §§1.171-2(a)(3)(ii), 1.1272-1(b)(1)(ii).
7. Treas. Reg. §1.171-2(a)(3)(iii).

If the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated by the holder as a bond premium deduction for the accrual period. However, the amount treated as a bond premium deduction is limited to the amount by which the holder's total interest inclusions on the bond in prior accrual periods exceeds the total amount treated by the holder as a bond premium deduction on the bond in prior accrual periods. A deduction determined under this rule is not subject to the 2 percent floor on miscellaneous itemized deductions.[1] If the bond premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as a deduction for the accrual period, the excess is carried forward to the next accrual period and is treated as bond premium allocable to that period.[2]

For bonds acquired on or after January 1, 2013, if there is such a bond premium carryfoward as of the end of the holder's accrual period in which the bond is sold, retired, or otherwise disposed of, the holder treats the amount of the carryfoward as a bond premium deduction under Section 171(a)(1) for the year in which such disposition occurs.[3]

Additional rules apply to determine the amortization of bond premium on a variable rate debt instrument, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules, and a bond that provides for remote or incidental contingencies.[4]

The regulations are generally effective for bonds acquired after March 2, 1998, but certain transition rules may have applied (see Q 7639).

Bonds Issued On or Before September 27, 1985

The amount of the deduction or offset each year may be determined under any reasonable method of amortization, but once an individual has used a method, the individual must consistently use the same method. (The Service has approved use of the "yield" method of amortizing bond premium).[5] Instead of any other method, he or she may use the straight line method set forth in regulations (in effect for bonds acquired before March 2, 1998, or held before a taxable year containing March 2, 1998). Under that method, the amount of premium that is deductible or offset each year is an amount that bears the same ratio to the bond premium as the number of months in the tax year the bond was held by the individual bears to the number of months from the beginning of the tax year (or, if the bond was acquired in the tax year, from the date of acquisition) to the date of maturity or to an earlier call date if appropriate. A fractional part of a month is counted only if it is more than one-half of a month and then it is counted as a month.[6] The additional regulations, amended December 30, 1997, do not include the above rules.

Under regulations in effect for bonds acquired before March 2, 1998 (or held before a taxable year containing March 2, 1998), if the premium is solely a result of capitalized expenses

1. Treas. Reg. §1.171-2(a)(4)(i)(A).
2. Treas. Reg. §1.171-2(a)(4)(i)(B).
3. Treas. Reg. §1.171-2(a)(4)(i)(C).
4. See Treas. Reg. §1.171-3.
5. Rev. Rul. 82-10, 1982-1 CB 46.
6. Treas. Reg. §1.171-2(f).

(such as buying commissions), an individual using the straight line method provided in the regulations may amortize the capital expenses. If such expenses are a part of a larger premium, the individual must treat them as part of the premium if he or she uses the straight line method.[1] The regulations, as amended December 30, 1997, do not include the above rule.

Earlier Call Date

If the bond is called before maturity, the amount of premium amortizable in that year is the excess of adjusted basis for determining loss over the greater of the amount received on call or the amount payable on maturity.[2]

Under regulations in effect for bonds acquired before March 2, 1998 (or held before a taxable year containing March 2, 1998), the earlier call date (if it is used to determine amortizable premium) may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer.[3] Where amortization is determined with respect to one of the alternative call dates, if in fact the bond is not called on that date, the premium must be amortized to a succeeding date or to maturity. The additional final regulations, amended December 30, 1997, do not include the above rules.

Basis Adjustment

Regulations in effect for bonds acquired before March 2, 1998 (or held before a taxable year containing March 2, 1998) provided that, in determining the amount of premium to be amortized each year, the basis was adjusted for amortizable premium previously deducted or offset.[4] Also, an adjustment had to be made for premium not amortized in years the individual held the bond before he elected to amortize. However, this adjustment was made only for the purpose of determining the amortizable amount; the amount not amortized before the election did not affect basis for determining gain or loss on sale or exchange.[5] If the bond was acquired by gift (or the individual's basis is for some other reason determined by reference to the basis in the hands of another), the same adjustment must include the period the bond was held by the other person. The regulations, as amended December 30, 1997, do not include the above rules.

Amortization Disallowed

The Service will disallow amortization in situations that lack economic substance.[6] A deduction for amortization was disallowed where sales were not bona fide sales;[7] and where an individual

1. Treas. Reg. §1.171-2(d).
2. IRC Sec. 171(b)(2).
3. Treas. Reg. §1.171-2(b).
4. Treas. Reg. §1.171-2(f)(2)(ii).
5. Treas. Reg. §1.171-2(a)(4).
6. Rev. Rul. 62-127, 1962-2 CB 84. With the 2010 codification of the economic substance doctrine, see IRC Sec. 7701(o), many transactions must pass scrutiny under this doctrine to be honored.
7. *Lieb v. Comm.*, 40 TC 161 (1963).

who put up no margin, signed no note, and intended to sell the bonds to cover his liability, was ruled not to be the owner of the bonds for purposes of deducting a part of the premium.[1]

Amortization of premium on tax-exempt bonds is discussed in Q 7646.

7641. How is amortizable bond premium determined in the case of a convertible bond?

The amount of amortizable bond premium on a convertible bond may not include any amount attributable to the bond's conversion features.[2] Under regulations generally in effect for bonds acquired on or after March 2, 1998 (see Q 7639), the holder's basis in the bond is reduced by an amount equal to the value of the conversion option. The value of the conversion option may be determined under any reasonable method. For example, the holder may determine the value of the conversion option by comparing the market price of the convertible bond to the market prices of similar bonds that do not have conversion options.[3]

> On January 1, 2014, John Smith purchases for $1,100 a convertible bond maturing on January 1, 2017, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $20.00 on January 1 and July 1 of each year. In addition, the bond is convertible into 15 shares of the corporation's stock at the option of the holder. On January 1, 2014, the corporation's nonconvertible, publicly-traded, 3-year debt with a similar credit rating trades at a price that reflects a yield of 4.50 percent, compounded semiannually.
>
> Mr. Smith's basis for determining loss on the sale or exchange of the bond is $1,100. As of January 1, 2014, discounting the remaining payments on the bond at the yield at which the corporation's similar nonconvertible bonds trade (4.50 percent, compounded semiannually) results in a present value of $985. Thus, the value of the conversion option is $115. Mr. Smith's basis is $985 ($1,100 - $115) for purposes of the rules and regulations of IRC Section 171. The sum of all amounts payable on the bond other than qualified stated interest is $1,000. Because Mr. Smith's basis (under IRC Section 171) does not exceed $1,000, he does not acquire the bond at a premium.

Regulations in effect for bonds acquired before March 2, 1998 (or held before a taxable year containing March 2, 1998) provided that the value of the conversion features is determined as of the date of acquisition by adjusting the price of the bond to a yield determined by comparison with the yields of bonds of similar character without conversion features that are sold on the open market.[4] The above language is not included in the regulations, as amended December 31, 1997.

Under the regulations, if a convertible bond is acquired in exchange for other property and the holder's basis in the bond is determined in whole or in part by reference to the holder's basis in the other property, the holder's basis in the bond may not exceed its fair market value immediately after the exchange reduced by the value of the conversion option.[5]

The amount of premium amortizable in a year is discussed in Q 7640. The tax treatment of the amount is explained in Q 7639.

1. *Starr v. Comm.*, 46 TC 450 (1966), *acq*. 1967-2 CB 3.7
2. IRC Sec. 171(b)(1).
3. Treas. Reg. §1.171-1(e)(1)(iii).
4. Treas. Reg. §1.171-2(c)(2).
5. Treas. Reg. §1.171-1(e)(iii)(B).

Municipal Bonds

7642. Is interest on obligations issued by state and local governments taxable?

Interest paid on certain 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 (see Q 7617 to Q 7620).

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 (see Q 7644, Q 653).[1]

Interest on general purpose obligations of states and local governments (i.e., states, territories, possessions of the United States, or political subdivisions of any of them, or the District of Columbia) issued to finance operations of the state, local government, or instrumentality is generally tax-exempt. In addition, some obligations are tax-exempt under special legislation.

In a case of first impression, the issue in Department of Revenue of Kentucky v. Davis was Kentucky's system of exempting from state income taxes the interest on bonds issued by Kentucky or its political subdivisions, but not on bonds issued by other states and their subdivisions—and specifically, whether that differential tax treatment violated the Commerce Clause of the United States Constitution. After paying state income tax on out-of-state municipal bonds, the taxpayers (George and Catherine Davis) sued for a refund claiming that Kentucky's differential taxation of municipal bond interest impermissibly discriminated against interstate commerce in violation of the Commerce Clause. The trial court granted judgment for the Commonwealth of Kentucky, but the Kentucky Court of Appeals reversed the trial court's ruling, finding that Kentucky's system of taxing only extraterritorial bonds ran afoul of the Commerce Clause. (The Supreme Court of Kentucky denied the motion for discretionary review by the Commonwealth of Kentucky). The Supreme Court of the United States (in a plurality opinion) reversed the judgment of the Kentucky Court of Appeals, and remanded the case. Relying primarily on recent precedent,[2] the Court stated that issuing debt securities to pay for public projects is a quintessentially public function with a venerable history, likely motivated by legitimate objectives distinct from simple economic protectionism. The Court determined that Kentucky's tax exemption system favored a traditional government function, without any differential treatment favoring local entities over substantially similar out-of-state interests and, thus, concluded that this type of law does not impermissibly discriminate against interstate commerce for purposes of the dormant Commerce Clause.[3]

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

1. IRC Sec. 57(a)(5).
2. *United Haulers Assn, Inc. v. Oneida-Herkimer Solid Waste Management Authority*, 550 U.S. 330 (2007).
3. *Department of Revenue of Kentucky et al. v. Davis et ux.*, 553 U.S. 328 (2008), reversing, 197 S.W.3d 557.

counsel," provide legal opinions concerning the validity of bond issues that 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 IRC Section 103(a).[1] Where a county housing authority refused to pay a rebate to the federal government relating to bonds that were ruled to be arbitrage bonds by the Service and not tax-exempt, the interest was not excludable from the gross income of bondholders under IRC Section 103(a).[2]

Where tax-exempt bonds trade "flat" because interest is in default, see Q 7653.

Bonds issued after June 30, 1983, must be in registered form in order to be tax-exempt (see Q 7682 and Q 7683).

Tax-exempt interest is included in the calculation made to determine whether Social Security payments are includable in gross income. It has been determined that although this provision may result in the indirect taxation of tax-exempt interest, it is not unconstitutional (see Q 590).[3] (The direct-indirect distinction probably does not matter anyway. The Supreme Court had held in 1988 that there is no constitutional requirement that interest on state and municipal bonds be excluded from the federal income tax base).[4]

Every person who receives tax-exempt interest (and who is required to file an income tax return) must report for informational purposes the amount of tax-exempt interest received during the tax year on that return.[5] The Code requires the reporting of tax-exempt interest paid after December 31, 2005.[6] The Service released transitional guidance regarding the information reporting requirements for payments of tax-exempt interest on state or local bonds.[7]

7643. What are Build America Bonds and how are they taxed?

ARRA 2009 created the Build America Bond program (under IRC Section 54AA), which authorized state and local governments to issue Build America Bonds as *taxable* governmental bonds in 2009 and 2010 to finance any governmental purpose for which tax-exempt governmental bonds could be issued. State and local governments could, at their option, issue two general types of Build America Bonds and receive federal subsidies for a portion of their borrowing costs. The subsidies took the form of either tax credits provided to holders of the bonds (tax credit type) or refundable tax credits paid to state and local governmental issuers of the bonds (direct payment type).[8]

"Build America Bond" means any taxable state or local governmental bond (excluding a private activity bond) that meets the following requirements: (1) the interest on such bond

1. Rev. Rul. 87-46, 1987-2 CB 44.
2. Harbor Bancorp v. Comm., 115 F.3d 722 (9th Cir. 1997).
3. *Goldin v. Baker*, 809 F.2d 187 (2nd Cir.), cert. denied, 484 U.S. 816 (1987).
4. See *South Carolina v. Baker*, 485 US 505 (1988).
5. IRC Sec. 6012(d).
6. See IRC Sec. 6049(b).
7. See Notice 2006-93, 2006-2 CB 798.
8. Notice 2009-26, 2009-1 CB 833.

would (but for IRC Section 54AA) be excludable from gross income under IRC Section 103; (2) the bond was issued before January 1, 2011; and (3) the issuer made an irrevocable election to have IRC Section 54AA apply.[1]

In general, Build America Bonds (tax credit type) could be issued to finance any governmental purpose for which tax-exempt governmental bonds (excluding private activity bonds) could be issued and must have complied with all requirements applicable to the issuance of tax-exempt governmental bonds.[2]

If a taxpayer holds a Build America Bond on one or more interest payment dates of the bond during any taxable year, a credit is allowed against the regular income tax liability in an amount equal to the sum of the credits determined under IRC Section 54AA(b) with respect to those dates.[3] The amount of the credit determined under IRC Section 54AA(b) with respect to any "interest payment date" for a Build America Bond is 35 percent of the interest payable by the issuer with respect to such date.[4] "Interest payment date" means any date on which the holder of record of the Build America Bond is entitled to a payment of interest from such bond.[5] Accordingly, the tax credit that a taxpayer may claim with respect to a Build America Bond (tax credit) is determined by multiplying the interest payment that the bondholder is entitled to receive from the issuer (i.e., the bond coupon interest payment) by 35 percent.[6]

The credit allowed under IRC Section 54AA(a) for any taxable year cannot exceed the *excess* of (1) the sum of the regular tax liability *plus* the alternative minimum tax liability, *over* (2) the sum of the credits generally allowable against the regular income tax (excluding the refundable credits and the Build America Bond tax credit).[7] Any excess is carried over to the succeeding taxable year and added to the credit allowable under IRC Section 54AA(a) for the taxable year.[8] Unused credit may be carried forward to succeeding taxable years.[9]

Original issue discount (OID) is not treated as a payment of interest for purposes of determining the credit.[10]

Interest on any Build America Bond is includable in gross income.[11]

7644. Is tax-exempt interest treated as an item of tax preference for purposes of the alternative minimum tax?

The answer is generally no. However, except as noted below with respect to private activity bonds issued in 2009 and 2010, tax-exempt interest on private activity bonds other than qualified

1. See IRC Sec.54AA(d), as added by ARRA 2009. Notice 2009-26, 2009-1 CB 833.
2. Notice 2009-26, 2009-16 CB 833.
3. IRC Sec. 54AA(a), as added by ARRA 2009. Notice 2009-26, 2009-1 CB 833.
4. IRC Sec. 54AA(b), as added by ARRA 2009. Notice 2009-26, 2009-1 CB 833.
5. IRC Sec. 54AA(e), as added by ARRA 2009. Notice 2009-26, 2009-1 CB 833.
6. Notice 2009-26, 2009-1 CB 833. See H.R. Conf. Rep. 111-16, 111th Cong., 1st Sess. (February 12, 2009).
7. IRC Sec. 54AA(c)(1), as added by ARRA 2009. Notice 2009-26, 2009-1 CB 833.
8. IRC Sec. 54AA(c)(2), as added by ARRA 2009. Notice 2009-26, 2009-1 CB 833.
9. See H.R. Conf. Rep. 111-16, 111th Cong., 1st Sess. (February 12, 2009). Notice 2009-26, 2009-1 CB 833.
10. Notice 2009-26, 2009-1 CB 833. See H.R. Conf. Rep. 111-16, 111th Cong., 1st Sess. (February 12, 2009), n. 146.
11. IRC Sec. 54AA(f)(1), as added by ARRA 2009.

501(c)(3) bonds is a tax preference item for both the individual and corporate alternative minimum tax (see Q 653). The interest may be reduced by any deduction not allowable in computing regular tax that would have been allowable if the interest were includable in gross income (e.g., amortizable bond premium).[1] The preference item includes exempt-interest dividends paid by a mutual fund to the extent attributable to such interest.[2]

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 is not an item of tax preference.[3]

Temporary modification of AMT limits on tax-exempt bonds issued in 2009 and 2010. The American Recovery and Reinvestment Act of 2009 (ARRA 2009) provided a temporary tax break for private activity bond interest. For private interest activity bonds issued during 2009 and 2010, interest from such bonds was *not* treated as a tax preference item for alternative minimum tax purposes.[4]

7645. How is gain or loss taxed on sale or redemption of tax-exempt bonds issued by a state or local government?

The seller may recover an amount equal to the seller's 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 (see Q 7646).

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 that accrued while owning the bond (subject to an adjustment if the owner purchased the bond at a price in excess of the issue price plus original issue discount accrued up to the time of acquisition).[5] Original issue discount accrues daily at a constant rate as it does generally for taxable original issue discount bonds issued after July 1, 1982 (see Q 7635), except that discounts of less than ¼ of 1 percent (.0025) times the number of years to maturity are accounted for.[6] For obligations with a maturity of one year or less, discount will accrue daily on a ratable basis, as it does for taxable short-term government obligations (that is, 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); however, the taxpayer apparently may make an irrevocable election to use a constant rate (under regulations) with respect to individual short-term obligations.[7]

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

1. IRC Sec. 57(a)(5)(A).
2. IRC Sec. 57(a)(5)(B).
3. See the Conference Report, TRA '86, page 333). IRC Sec. 57(a)(5)(C).
4. See IRC Sec. 57(a)(5)(C)(vi), as added by ARRA 2009; Sec. 1503 of ARRA 2009.
5. IRC Sec. 1288(a)(2).
6. IRC Sec. 1288(b)(1).
7. IRC Sec. 1288(b).

original issue discount accrued up to the date of sale.[1] 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 that 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 the holder 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.[2] 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.[3]

Stated interest that is unconditionally payable at maturity on short-term tax-exempt bonds may be treated as includable in the stated redemption price at maturity *or* as qualified stated interest, at the choice of the taxpayer, provided all short-term tax-exempt bonds are treated in a consistent manner. This guidance is effective for tax-exempt bonds issued after April 4, 1994, and until the Service provides further guidance.[4] Scheduled interest payments are not unconditionally payable when, under the terms of a debt instrument, the failure to make interest payments when due requires that the issuer forgo paying dividends, or that interest accrue on the past-due payments at a rate that is two percentage points greater than the stated yield.[5]

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 a return of capital.[6]

Gain in excess of tax-exempt interest will generally be capital gain, including gain from any premium paid on call (see Q 7648). See Q 608 regarding the treatment of capital gains and losses.

If the bond was bought on the market at 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.[7] 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).

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.[8] For tax-exempt bonds purchased *before* May 1, 1993, gain attributable to market discount has generally been treated by the Service as capital gain.[9] Capital gain is not exempt from federal income tax.[10]

1. TAM 8541003.
2. Rev. Rul. 73-112, 1973-1 CB 47.
3. Rev. Rul. 80-143, 1980-1 CB 19; Rev. Rul. 72-587, 1972-2 CB 74.
4. Notice 94-84, 1994-2 CB 559.
5. See Rev. Rul. 95-70, 1995-2 CB 124.
6. See Rev. Rul. 69-263, 1969-1 CB 197.
7. Rev. Rul. 73-112, above; Rev. Rul. 60-210, 1960-1 CB 38; Rev. Rul. 57-49, 1957-1 CB 62.
8. IRC Secs. 1276(a), 1278(a)(1).
9. Rev. Rul. 60-210, above; Rev. Rul. 57-49, above.
10. *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.

If a loss is realized on the sale or on a redemption, it is a capital loss. However, if "substantially identical" obligations were acquired (or a contract to acquire them was made) within 30 days before or 30 days after the sale, the loss will be subject to the "wash sale" rule discussed in Q 7535.

The IRS concluded that a modification of tax-exempt revenue bonds constituted a deemed exchange under IRC Section 1001 because the modified bonds, which had been issued in an exchange, were materially different from the original bonds. Thus, the modified bonds would be treated as newly issued securities for federal income tax purposes.[1]

The installment method for recognizing and taxing gain is not available for securities traded on an established securities market. As a result, gain from sale is included in income for the year in which the trade date occurs even if one or more payments are received in the subsequent tax year.[2]

If the bond traded "flat" because interest was in default, see Q 7653.

Bonds issued after June 30, 1983, must be in registered form in order to deduct loss on sale or to treat gain as capital (as opposed to ordinary) gain (see Q 7682, Q 7683).

If the bond was held as part of a tax straddle, see Q 7587 to Q 7603. If the bond was held as part of a conversion transaction, the additional rules discussed in Q 7604 and Q 7605 will apply.

If the transfer is between spouses, or between former spouses and incident to divorce, see Q 660.

7646. Is premium paid for a tax-exempt bond deductible? Must basis in a tax-exempt bond be reduced by bond premium?

An individual who owns any fully tax-exempt interest bearing bond (or debenture, note, certificate, or other evidence of indebtedness) *must* amortize any premium paid for the bond, but the part of the premium allocable to the year is not deductible.[3] (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, the premium is not deductible). Regulations in effect for bonds acquired before March 2, 1998 (or held before a taxable year containing March 2, 1998) provided substantially similar rules. See Q 7647 for an explanation of the effective date for final regulations under IRC Section 171. The individual *must* reduce his or her basis each year by the amount of premium allocable to the year.[4]

For an explanation of how the annual amount of amortization is calculated, see Q 7647.

1. FSA 200116012.
2. IRC Sec. 453(k). See Rev. Rul. 93-84, 1993-2 CB 225.
3. IRC Sec. 171; Treas. Reg. §1.171-1(c).
4. IRC Sec. 1016(a)(5).

7647. How is premium on tax-exempt bonds amortized?

Bond premium that must be amortized is the amount by which an individual's tax basis for determining *loss* (adjusted for prior years' amortization) exceeds the face amount of the bond at maturity (or earlier call date in the case of a callable bond).[1] (A taxpayer's basis for determining loss can be lower than basis for determining gain, as in the case of a gift (see Q 598)).

Under the regulations, which are generally effective for bonds acquired on or after March 2, 1998 (see Q 7639), a holder amortizes bond premium by offsetting qualified stated interest allocable to an accrual period with the bond premium allocable to the accrual period.[2] Bond premium is allocable to an accrual period based on a constant yield that is used to conform the treatment of bond premium to the treatment of original issue discount (see Q 7635).[3]

For the purpose of determining the amount amortizable, if the bond is acquired in an exchange for other property and the bond's basis is determined (in whole or in part) by the basis of the property, the basis of the bond is not more than its fair market value immediately after the exchange.[4] This rule applies to exchanges occurring after May 6, 1986.

Calculation of Amount Amortized

Bonds Issued After September 27, 1985

Except as provided in the regulations (see below), the annual amortizable amount is computed on the basis of the taxpayer's yield to maturity by using the taxpayer's basis in the bond (for purposes of determining loss) and by compounding at the close of each accrual period. (The accrual period is determined as discussed in Q 7635). If the amount payable on a call date that is earlier than maturity is used for purposes of determining the yield to maturity, the bond is treated as maturing on the call date and then as reissued on that call date for the amount payable on the call date.[5]

Under the regulations generally in effect for bonds acquired on or after March 2, 1998, a holder amortizes bond premium under the same rules that apply to taxable bonds (see Q 7640); however, in the case of tax-exempt bonds, bond premium in excess of qualified stated interest is treated under a separate rule. If the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is a nondeductible loss.[6]

See Q 7639 for an explanation of the effective date of the regulations under IRC Section 171.

Bonds Issued on or Before September 27, 1985

The amount of the premium allocable to each year may be determined under any reasonable method of amortization, but once an individual has used a method, he or she must consistently

1. IRC Sec. 171(b)(1).
2. Treas. Reg. §1.171-2.
3. Treas. Reg. §1.171-1. See also Treas. Reg. §1.171-2(c), Ex. 4.
4. IRC Sec. 171(b)(4).
5. IRC Sec. 171(b)(3).
6. Treas. Reg. §1.171-2(a)(4)(ii).

use the same method. (The Service has approved use of the "yield" method of amortizing bond premium).[1] Instead of any other method, a taxpayer may use the straight line method set forth in the regulations. Under that method, the amount of premium that is allocable to each year is an amount that bears the same ratio to the bond premium as the number of months in the tax year the bond was held by the individual bears to the number of months from the beginning of the tax year (or, if the bond was acquired in the tax year, from the date of acquisition) to the date of maturity or to an earlier call date if appropriate. A fractional part of a month is counted only if it is more than one-half of a month and then it is counted as a month.[2] The regulations, as amended December 30, 1997, do not include the above rules.

If the premium is solely a result of capitalized expenses (such as buying commissions), an individual using the straight line method provided in the regulations may amortize the capital expenses; if such expenses are a part of a larger premium, the individual must treat them as part of the premium, if he or she uses the straight line method.[3] The regulations, as amended December 30, 1997, do not include the above rules.

Where there is more than one call date, the premium paid for a tax-exempt bond must be amortized to the *earliest* call date.[4] If the bond is not called at that date, the premium is then amortized down to the next lower call price, and so on to maturity.[5] The Service apparently reasons that because amortization is mandatory in the case of tax-exempt bonds, the entire premium must be subject to amortization.

> *Example*: A $100 bond is acquired at the time of issue for $125. The bond is callable in five years at $115 and in 10 years at $110. The individual may amortize $10 of the premium during the first five years and, if the bond is not then called, an additional $5 of premium during the next five years. If the bond is not called at the end of 10 years, the remaining $10 of premium must be amortized to maturity.

7648. Is premium paid on call of a tax-exempt bond before maturity tax-exempt interest?

No, it is a capital payment taxable as capital gain.[6] See Q 7645 if the bond was originally issued at a discount. For the treatment of capital gains and losses, see Q 608.

7649. Is interest on a tax-exempt municipal bond paid by a private insurer because of default by the state or political subdivision tax-exempt?

Yes, interest that would have been tax-exempt if paid by the issuer will be tax-exempt if paid by a private insurer on the issuer's default.[7] 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.[8]

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1. Rev. Rul. 82-10, 1982-1 CB 46.
2. Treas. Reg. §1.171-2(f).
3. Treas. Reg. §1.171-2(d).
4. *Pacific Affiliate, Inc. v. Comm.*, 18 TC 1175 (1952), *aff'd*, 224 F.2d 578 (9th Cir. 1955), *cert. den.*, 350 U.S. 967 (1956).
5. Rev. Rul. 60-17, 1960-1 CB 124.
6. Rev. Rul. 72-587, 1972-2 CB 74; GCM 39309 (11-28-84); see also Rev. Rul. 74-172, 1974-1 CB 178; *District Bond Co. v. Comm.*, 1 TC 837 (1943); *Bryant v. Comm.*, 2 TC 789 (1943), *acq.* 1944 CB 4.
7. Rev. Rul. 72-134, 1972-1 CB 29.
8. 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. If, at the time the contract 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, then the agreement will be considered both incidental to the bonds and not a separate debt instrument or similar investment. Under these circumstances, a bondholder may exclude interest paid or accrued under an agreement for defaulted interest.[1]

If the interest or principal is guaranteed by the federal government, see Q 7650.

7650. Is interest on municipal bonds tax-exempt if payment is guaranteed by the United States 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.[2]

Generally, an obligation issued after 1983 is federally guaranteed if payment of principal or interest (in whole or in part, directly or indirectly) is guaranteed by: the United States, any U.S. agency, or, 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 if proceeds of the issue are to be used in making loans so guaranteed.[3]

Exceptions to this rule include certain bonds guaranteed by the Federal Housing Administration, the Department of Veterans Affairs, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association, and the Student Loan Marketing 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 issued or guaranteed by Connie Lee Insurance Company are not considered "federally guaranteed."[4]

Some state and local obligations are secured by certificates of deposit federally insured by the Savings Association Insurance Fund (SAIF–formerly the Federal Savings and Loan Insurance Corporation (FSLIC)) or the Federal Deposit Insurance Corporation (FDIC) up to $250,000 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 percent or more of the proceeds of the issue is to be invested in federally insured deposits or accounts.[5]

The IRS ruled that interest on refunding bonds that were issued in an advance refunding of previously issued private activity bonds would be excludable from gross income under IRC Section 103(a).[6]

1. Rev. Rul. 94-42, 1994-2 CB 15.
2. IRC Sec. 149(b)(1); Treas. Reg. §1.149(b)-1.
3. IRC Sec. 149(b).
4. Notice 88-114, 1988-2 CB 449.
5. IRC Sec. 149(b)(2)(B).
6. Let. Rul. 200139007.

7651. Are interest and expense deductions limited because of ownership of municipal bonds?

If interest is paid on loans by an individual who owns tax-exempt municipal bonds, deduction of the interest may be partly or entirely denied (see Q 7943). In addition, some expense deductions may be denied to individuals holding obligations – the interest on which is tax-exempt (see Q 7949).

7652. If the interest on an obligation issued by a state or local government is not tax-exempt, how is it taxed?

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 (see Q 7611 to Q 7613).[1] Other bonds are treated like U.S. Treasury notes and bonds (see Q 7617 to Q 7620).[2]

Other Issues Affecting Bonds

7653. How are the buyer and seller taxed on a bond bought or sold "flat"?

Bonds on which interest or principal payments are in default may be quoted "flat," that is, without any allocation in the quoted price between accrued but unpaid interest and principal.

The purchaser of a bond quoted flat treats any payment received attributable to interest that accrued before the purchase of the bond as a return of capital that reduces basis. Amounts received in excess of the tax basis in the bond are capital gain.[3] They are not treated as interest.[4] Thus, if the bond is a tax-exempt municipal bond, return of interest accrued prior to acquisition reduces the owner's basis, and any excess is taxable as capital gain, not tax-free interest.[5]

The owner of a bond, whether or not purchased flat, treats any payment of interest attributable to defaulted interest that accrued after the purchase of the bond as 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.[6]

Thus, where the face amount and all interest accrued before and after purchase is paid in full on redemption of the bonds by the obligor, the amount of interest accrued after purchase is interest and the balance of the proceeds is return of capital, which is tax-free to the extent of the purchaser's basis, and capital gain to the extent it exceeds basis.[7] See Q 608 for the treatment of capital gains and losses.

1. IRC Sec. 1271(a)(3); IRC Sec. 454(b).
2. IRC Secs. 1271 and 1272.
3. *Rickaby v. Comm.*, 27 TC 886 (1957), *acq.* 1960-2 CB 6; Rev. Rul. 60-284, 1960-2 CB 464.
4. *First Ky. Co. v. Gray*, 190 F. Supp. 824 (W.D. Ky. 1960), *aff'd*, 309 F.2d 845 (6th Cir. 1962).
5. *R.O. Holton & Co. v. Comm.*, 44 BTA 202 (1941); *Noll v. Comm.*, 43 BTA 496 (1941).
6. *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); *Tobey v. Comm.*, 26 TC 610 (1956), *acq.* 1956-2 CB 8; *Shattuck v. Comm.*, 25 TC 416 (1955); *First Ky. Co. v. Gray*, above; Rev. Rul. 60-284, above.
7. *Tobey v. Comm.*, above.

But where the amount received on a flat sale or on redemption is less than the entire amount due (principal and interest), the amount recovered is allocated between principal and interest accruing while the seller held the bond under the following formula:[1]

$$\frac{\text{purchase price allocable to interest accrued while Seller owned bond}}{\text{amount received on sale}} = \frac{\text{face amount of interest accrued while Seller owned bond}}{\text{face amount of principal and interest due at sale}}$$

However, the appeals court in *Jaglom* suggested (but did not decide because the question was not appealed) that where a sale occurred in anticipation of imminent payment by the debtor, the fair market value of principal and interest would be more appropriately used in the formula than face value.

If a bond was held as part of a tax straddle, the additional rules and qualifications explained in Q 7587 to Q 7603 apply. If a bond was held as part of a conversion transaction, the rules as explained in Q 7604 and Q 7605 will apply.

7654. What is a zero coupon bond? How is the owner taxed?

Zero coupon bonds are obligations payable without interest at a fixed maturity date and issued at a deep discount. Maturities can range from short-term to long-term. For tax purposes, they are considered original issue discount bonds, and the original issue discount is included in ordinary income depending on when issued, as explained in Q 7622 and Q 7635 to Q 7638.[2] In the case of a tax-exempt zero-coupon bond, the original issue discount is apportioned among holders as explained in Q 7636, but not included in income.[3]

7655. What is a stripped bond?

A stripped bond is a bond issued with interest coupons where the ownership of any unmatured coupon is separated from the ownership of the rest of the bond.[4] It may be a Treasury, corporate, or municipal obligation. With respect to purchases after July 1, 1982, a coupon includes any right to interest.[5]

In 2002, the Service released guidance on the application of the coupon stripping rules to certain fees payable out of mortgage payments received by mortgage pool trusts.[6]

In 2008, the Treasury Department lowered the minimum and multiple amounts of Treasury marketable notes, bonds, and Treasury Inflation-Protected Securities (TIPS) that may be stripped from $1,000 to $100. The change applies to all Treasury marketable securities eligible

1. *Jaglom v. Comm.*, above. See also *First Ky. Co. v. Gray*, above, and *Shattuck v. Comm.*, above.
2. Rev. Rul. 75-112, 1975-1 CB 274.
3. Rev. Rul. 73-112, 1973-1 CB 47.
4. IRC Sec. 1286(e)(2).
5. IRC Sec. 1286(e)(5).
6. See Chief Counsel Notice CC-2002-016 (January 24, 2002).

for stripping (notes, bonds, plus TIPS issued after January 15, 1985) outstanding on and after April 7, 2008.[1]

7656. How is an individual taxed who sells separately the corpus or coupons of a taxable bond originally acquired as a unit?

After July 1, 1982

If an individual strips one or more unmatured coupons (or rights to interest) from a taxable bond and, after July 1, 1982, disposes of the bonds or the coupon(s), the tax treatment is as follows:

(1) he or she must include in income (a) any interest accrued but not yet due on the bond at the time of sale (and not already included in income), and (b) with respect to obligations acquired after October 22, 1986, any accrued market discount on the bond (not already included in income);

(2) he or she must then increase tax basis in the bond and coupon(s) by the amount of accrued interest and market discount included in income ((1) above);

(3) he or she must allocate the tax basis immediately before disposition (as increased in (2) above) among the items retained and those disposed of in proportion to their respective fair market values;

(4) the individual is then treated as if he or she purchased on the date of disposition any part retained for an amount equal to the basis allocated to the item. The individual is taxed on the part retained as if it were an original issue discount (OID) obligation issued on the date of purchase. The amount of OID is the excess of the amount payable at maturity of the bond or the due date of the coupon, whichever is applicable, over the purchase price. Under regulations effective after August 7, 1991, the discount is disregarded if it is less than ¼ of 1 percent (.0025) of the amount so payable multiplied by the full number of years from the date the stripped bond or coupon was purchased to final maturity.[2] A person who strips a taxable bond or coupon must include in income original issue discount on the part retained as it accrues without regard to whether it is considered a short-term or long-term obligation; and

(5) the individual recognizes gain or loss on the part he or she sells to the extent the amount realized exceeds or is less than the basis allocated to the part sold; the part sold is treated by the buyer as an original issue discount bond issued on the date of purchase, as discussed in Q 7657.[3]

Transfers between spouses, or between former spouses if incident to divorce, are discussed in Q 660.[4]

1. 31 Uniform Offering Circular CFR Part 356, 73 Fed. Reg. 14937 (3-20-2008).
2. Treas. Reg. §1.1286-1(a).
3. IRC Sec. 1286.
4. IRC Sec. 1041.

Before July 2, 1982

A taxpayer who stripped bonds and then sold the bonds and retained the detached coupon properly allocated his or her entire basis to the stripped bonds and was not required, for purposes of determining loss, to allocate basis between the coupons detached and retained and the stripped bonds sold (as is required for transactions occurring after July 1, 1982).[1] However, the taxpayer was required to treat the coupon as a right to interest, so that on sale or redemption of the coupons, the entire proceeds would have been characterized as interest.[2]

7657. How is an individual taxed when a stripped taxable bond corpus or coupon is purchased after July 1, 1982?

A stripped taxable bond or coupon is considered, for tax purposes, as an original issue discount (OID) bond issued at the time of purchase. The discount is the amount by which the stated redemption price at maturity of the bond, or the amount payable on the due date of the coupon, exceeds its ratable share of the purchase price.[3] Under regulations effective after August 7, 1991, the discount is disregarded if it is less than ¼ of 1 percent (.0025) of the amount so payable multiplied by the full number of years from the date the stripped bond or coupon was purchased to final maturity.[4]

The owner must include in income each year a portion of the discount and increase tax basis each year by the amount included. See Q 7635. (Ratable shares of the purchase price are determined on the basis of respective fair market values on the date of purchase.) The amount of discount that accrues each day is determined the same way as the amount of original issue discount on an OID bond that has not been stripped, using the acquisition price instead of issue price in the formula and increasing the acquisition price each accrual period by the amount accrued in the previous period. A stripped coupon has no stated interest for purposes of the formula. See Q 7635. On sale or redemption, any gain or loss is generally capital gain or loss. Where leveraging is used to purchase or carry stripped coupons or bonds (acquired after July 18, 1984) that are payable not more than one year from the date of purchase, it is possible, but not at all clear, that the rules deferring the deductibility of interest expense on short-term obligations may apply. See Q 7944.[5]

7658. How is an individual taxed on a stripped taxable bond corpus or coupon purchased on or before July 1, 1982?

On sale of a *bond* that was bought without all unmatured coupons before July 2, 1982, and after December 31, 1957 (or purchased on or before December 31, 1957, but after August 16, 1954, without all coupons maturing more than 12 months after the date of purchase), any gain recognized must be treated as ordinary income up to the amount by which the fair market value the obligation would have had at the time of purchase *with* the coupons was greater than the actual price the individual paid for the bond without the coupons.[6] Gain in excess of that

1. TAM 8602006.
2. Rev. Rul. 58-275, 1958-1 CB 22.
3. IRC Sec. 1286(a).
4. Treas. Reg. §1.1286-1(a).
5. See General Explanation–TRA '84, pp. 92, 102.
6. IRC Sec. 1286(c); Treas. Reg. §1.1232-4.

amount may generally be treated as capital gain;[1] however, the bond, if originally issued at a discount, may also be subject to the rules discussed in Q 7637.

On sale of *coupons* bought separately from the bond corpus, any interest accrued but not due at the time an individual purchased a detached coupon and for which the buyer paid the seller is recovered tax-free. Any additional gain *on sale* of coupons bought separately prior to maturity is capital gain, but the same gain *on redemption* at maturity is ordinary income.[2] Where a series of coupons is purchased in a block, the cost is allocated among the individual coupons by taking their maturity dates into account.[3]

7659. If tax-exempt bonds are stripped, how are the purchaser and seller of the stripped bond or coupons taxed?

If an individual strips one or more unmatured coupons from a tax-exempt bond and, after July 1, 1982, disposes of the bond or the coupon(s), the individual must increase the tax basis of the bond by any interest accrued but not paid up to the time of disposition and allocate this tax basis between the items disposed of and the items retained, in proportion to their respective fair market values. (He or she does not include the interest in income.) If the individual strips coupons after October 22, 1986, he or she must also increase basis by accrued original issue discount prior to allocation of basis among the items retained and the items disposed of. The calculation of this original issue discount is explained below. If an individual strips coupons after June 10, 1987, he or she must also calculate the amount of original issue discount that is allocable to the "tax-exempt portion" of the stripped bond or coupon. Any excess over this amount will be treated as original issue discount attributable to a taxable obligation.[4]

After June 10, 1987

In the case of a tax-exempt bond stripped after June 10, 1987, a portion of the original issue discount may be treated as if it comes from a taxable obligation. The "tax-exempt portion" of the original issue discount is the excess of the obligation's stated redemption price at maturity (or the amount payable on a coupon's due date) over an issue price that would produce a yield to maturity as of the purchase date of the stripped bond or coupon equal to the lower of (1) the coupon rate of interest on the obligation from which the coupons were stripped, or (2) the yield to maturity (on the basis of the purchase price) of the stripped coupon or bond. Alternatively, the purchaser may use the original yield to maturity in (1), above, rather than the coupon rate of interest.[5]

Any original issue discount in excess of the "tax-exempt portion" will be treated as discount on an obligation that is not tax-exempt.[6] The person who strips the bond increases basis by any interest and market discount accrued on the bond but not yet paid before the disposition, to the extent that such amounts have not previously been reflected in basis.[7]

1. *Hood v. Comm.*, TC Memo 1961-231.
2. Rev. Rul. 58-536, 1958-2 CB 21; Rev. Rul. 54-251, 1954-2 CB 172.
3. Rev. Rul. 54-251, above.
4. IRC Sec. 1286(d).
5. IRC Sec. 1286(d).
6. IRC Sec. 1286(d)(1)(A)(ii).
7. IRC Sec. 1286(d)(1)(C).

October 23, 1986 through June 10, 1987

In the case of a tax-exempt bond stripped after October 22, 1986, and before June 11, 1987, the amount of original issue discount that is added to the basis of the person who strips the bond is the amount that produces a yield to maturity (as of the purchase date) equal to the lower of (1) the coupon rate before the separation or (2) the yield to maturity (on the basis of purchase price) of the stripped obligation or coupon. The holder increases basis by this amount (prior to allocating basis between the parts retained and disposed of) and is then treated as having purchased on the date of disposition any part retained for an amount equal to the tax basis allocated to the retained item.[1]

An individual who purchased a stripped tax-exempt bond or coupon after October 22, 1986, but before June 11, 1987 (except as provided below) is treated as if he or she bought a tax-exempt obligation issued on the purchase date having an original issue discount equal to an amount that produces a yield to maturity of the lower of: (a) the coupon rate of interest before separation, or (b) the yield to maturity, on the basis of purchase price, of the obligation or coupon.[2] The holder's basis is adjusted to reflect the discount so determined as it accrues at a constant interest rate, but the accruing discount is not included in income.[3] This rule also applies to obligations purchased after June 10, 1987, if such bond or coupon was held in stripped form by the dealer on June 10, 1987.

Before October 23, 1986

An individual who purchased after December 31, 1957, and before October 23, 1986, a stripped tax-exempt bond without *all* unmatured coupons (or after August 16, 1954, but before January 1, 1958, without all coupons maturing more than 12 months after purchase) treats, on subsequent disposition of the bond, any gain as *ordinary income* to the extent the fair market value with coupons attached exceeds the actual purchase price.[4] The IRC does not clarify, for purposes of these pre-October 23, 1986, purchases, whether "ordinary income" is to be treated as tax-exempt interest.

7660. When is the interest on United States Savings Bonds Series E or EE taxed?

United States savings bonds (Series E before 1980 and Series EE after), including Patriot Bonds (see Q 7662), are issued on a noninterest bearing discount basis. Interest accrues at stated intervals and becomes part of the redemption value paid when the bond is cashed or finally matures. The difference between the price paid and the larger redemption value is interest. Savings bonds continue to accrue interest after the stated maturity until the Treasury announces discontinuance of payments, generally after 30 years. For the new method of calculating interest, see Q 7663. This interest is subject to all federal taxes (unless it qualifies for the exclusion described in Q 7667), and the bonds are subject to federal and state estate, inheritance, gift, or other excise taxes, but not state or local taxes on principal or interest.[5] Bonds held less than five years from issue date are subject to a 3-month interest penalty.

1. IRC Sec. 1286(d), prior to amendment by TAMRA '88.
2. IRC Sec. 1286(d).
3. IRC Sec. 1286(d)(2), prior to amendment by TAMRA '88.
4. IRC Sec. 1286(d) (prior to amendment by TRA '86).
5. 31 CFR §351.8(a).

7661. What is the minimum holding period applicable to United States Savings Bonds Series EE and I?

In 2003, the Treasury Department extended the minimum holding period applicable to United States savings bonds from 6 to 12 months, effective with issues dated on and after February 1, 2003. The minimum holding period is the length of time from issue date that a bond must be held before it is eligible for redemption. Both Series EE and Series I savings bonds are affected. Series EE and Series I savings bonds bearing issue dates prior to February 1, 2003, retain the 6-month holding period in effect when they were issued.[1]

7662. How is the interest on United States Savings Bonds Series E or EE calculated?

The Treasury Department has announced that Series EE savings bonds issued on and after May 1, 2005, will earn fixed, instead of variable, rates of interest.[2] Previously, a new variable rate was announced each May 1 and November 1, and applied to bonds during the first semiannual rate period beginning on or after the effective date of the rate. Consequently, a Series EE bond purchased prior to May 1, 2005, earned a new rate of interest every six months. However, a Series EE bond purchased on or after May 1, 2005, will have one rate of interest that will continue for the life of the bond (although a different rate or method of determining the rate may be used for any extended maturity period).

The interest rate for a Series EE bond issued on or after May 1, 2005, will be a fixed rate of interest as determined by the Secretary of the Treasury and announced each May 1 and November 1. The most recently announced fixed rate will apply to Series EE bonds purchased during the six months following the announcement (or for any other period of time announced by the Secretary). The fixed rate will be established for the life of the bond, including the extended maturity period, unless the Secretary announces a different fixed rate or amends the terms and conditions prior to the beginning of the extended maturity period. All other Series EE terms and conditions remain unchanged. These changes do not affect bonds that were purchased before May 1, 2005.[3]

7663. How is interest earned on United States Savings Bonds Series E, EE or I reported?

Deferred reporting of interest. An owner of E, EE, or Series I savings bonds (see Q 7670) who reports on a cash basis may treat the increase in redemption value, for federal income tax purposes, in either of two ways:

(1) the owner may defer reporting the increase to the year of maturity, redemption, or other disposition, whichever is earlier; or

(2) the owner may elect to treat the increase as income each year as it accrues.[4]

1. See News Release (1-15-2003) at: http://publicdebt.treas.gov/.
2. See News Release (5-2-2005), at: http://www.treasurydirect.gov/news/pressroom/pressroom_comee0505.htm
3. See Final Rule, Offering of United States Savings Bonds, Series EE, 31 CFR Part 351, 70 Fed. Reg. 17288 (4-5-2005).
4. IRC Sec. 454(a).

Ordinarily, an election made by the owner of an E, EE, or I bond to report interest annually applies to all E, EE, and I bonds then owned or subsequently acquired.[1] However, a taxpayer who reports interest annually may elect to change to deferred reporting with automatic consent of the IRS, provided certain requirements are met. To obtain *automatic consent* for the taxable year for which the change is requested, the taxpayer may file a *statement* in lieu of Form 3115.[2] The statement must be identified at the top as follows: "CHANGE IN METHOD OF ACCOUNTING UNDER SECTION 6.01 OF THE APPENDIX OF REV. PROC. 2002-9." The statement must set forth:

(i) the Series E, EE, or I savings bonds for which the change in accounting method is requested;

(ii) an agreement to report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest; and

(iii) an agreement to report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of any interest income previously reported in prior taxable years.

The statement must include the name and Social Security number of the taxpayer underneath the heading.[3] The change is effective for any increase in redemption price occurring after the beginning of the year of change for all Series E, EE, and I savings bonds held by the taxpayer on or after the beginning of the year of change.[4] The taxpayer must attach the signed statement to his or her tax return for the year of the change, which must be filed by the due date (including extensions).[5] (Alternatively, instead of filing the statement, the taxpayer can request permission to change from deferred reporting to annual reporting by filing Form 3115 and following the form instructions for an automatic change.) If the taxpayer is precluded from using the automatic consent procedure under Revenue Procedure 2002-9, above, the taxpayer must file Form 3115 in accordance with the regulations.[6]

Taxpayers may switch from deferred reporting to annual reporting in any year without permission; however, an election under Revenue Procedure 2002-9 may not be made more than once in any 5-year period.[7] The year of change is *included* within the 5-year prohibition regarding prior changes.[8]

The election to treat accruing interest as income annually is made by including the interest in gross income on the owner's tax return for the year he or she makes the election.[9] It may not be made by amended return.[10] The owner must include (in the year of election) the increase in the redemption price of all the owner's E, EE, and I bonds that has occurred since the date of acquisition. If he or she owns any bond (such as H or HH) that retains interest deferred on an

1. See IRS Pub. 550.
2. Rev. Proc. 2002-9, 2002-1 CB 327, Appendix 6.01, as modified by Rev. Proc. 2013-20, 2013-1 CB 744; Rev. Proc.2008-52, 2008-2 CB 587.
3. See IRS Pub. 550.
4. Rev. Proc. 2002-9, above, Appendix Sec. 6.01.
5. IRS Pub. 550.
6. Rev. Proc. 2002-9, above, Sec. 4.03.
7. See Rev. Proc. 2002-9, above, Sec. 4.02(6); IRC Sec. 454; 31 CFR §351.8(b).
8. Rev. Proc. 2002-9, above, Sec. 4.02(6).
9. IRC Sec. 454(a).
10. Rev. Rul. 55-655, 1955-2 CB 253.

E or EE bond, that interest must also be reported.[1] After making the election, the owner must include the actual increase in redemption value that occurs on the stated intervals in each year. (This is not necessarily the amount that would accrue ratably.)[2]

A bond owner whose income is not sufficient to require filing a return is not deemed to have automatically elected to treat accruing interest as income; however, the election may be made by filing a return reporting the interest, even though no return is otherwise required.[3]

A previous election to report annual increases in redemption value does not bind anyone to whom the bond is transferred.[4] For example, an executor who elects to include deferred interest in an estate's income is not bound by the election to report annually when the bond is transferred to the executor in his or her capacity as trustee of a trust created under a will.[5]

To the extent the increase in redemption value (interest) has not been includable in gross income previously by the taxpayer or any other taxpayer, it is included by a cash basis taxpayer for the tax year in which the obligation is redeemed or disposed of.[6] (For an explanation of the exclusion for interest on certain Series EE and Series I bonds used for educational expenses, see Q 7666.) If the obligation is partially redeemed or partially disposed of by being partially reissued to another person, the increase is included in income by the taxpayer in proportion to the total denominations redeemed or disposed of.[7]

Similarly, where Series E and EE bonds were transferred incident to a divorce, the transferor was required to include unrecognized interest as income in the year of transfer. The transferee's basis in such bonds was adjusted by adding the amount of interest includable by the transferor.[8]

Previously, an individual could, at maturity or before, exchange a Series E or EE bond for a Series HH bond (or Series H bond before 1980–but see *Editor's Note*, Q 7669) without recognizing the unreported interest, except that he or she must report the interest to the extent cash is received in the exchange.[9]

Transfer of an E/EE bond to a revocable personal trust does not require inclusion of unreported interest in income because the grantor continues to be considered the owner of the bonds.[10] Reissuance of a Series H bond (received in exchange for a Series E bond on which reporting of interest has been deferred) to a trustee of a trust where the trust corpus will revert to the grantor and any previously unreported interest is allocable to corpus, will not result in inclusion of the previously unreported interest in the grantor's income. The grantor will include the interest in his gross income in the year the bond is redeemed, disposed of, or reaches final maturity.[11]

1. IRC Sec. 454(a).
2. Treas. Reg. §1.454-1(a)(2).
3. *Apkin v. Comm.*, 86 TC 692 (1986).
4. Treas. Reg. §1.454-1(a).
5. Rev. Rul. 58-435, 1958-2 CB 370.
6. See, e.g., *Landers v. Comm.*, TC Memo 2003-300.
7. Treas. Reg. §1.454-1(c).
8. Rev. Rul. 87-112, 1987-2 CB 207.
9. IRC Sec. 1037(a); TD Circular, Pub. Debt Series No. 1-80, 1980-1 CB 715; 31 CFR §352.7(g)(3).
10. Rev. Rul. 58-2, 1958-1 CB 236; Let. Rul. 9009053.
11. Rev. Rul. 64-302, 1964-2 CB 170.

Surrender of an E bond, bought entirely with one co-owner's funds, by the co-owner for reissue in the sole name of the other co-owner causes recognition of unreported appreciation to the date of reissue in the purchasing co-owner's name (see also Q 766 regarding the gift).[1] However, if the bond is reissued in the sole name of the co-owner who originally purchased the bond with his or her own funds, there is no taxable transaction.[2]

7664. What is a Patriot Bond? How are Patriot Bonds taxed?

Patriot Bonds are regular Series EE Savings Bonds specially inscribed with the legend "Patriot Bond." As with regular Series EE Savings Bonds, Patriot Bonds are sold at one-half of face value ($50, $75, $100, $200, $500, $1,000, $5,000, and $10,000). Patriot Bonds earn 90 percent of 5-year Treasury security yields. Patriot Bonds increase in value monthly, but interest is compounded semiannually. Interest on Patriot Bonds is exempt from state and local income taxes; federal tax can be deferred until the bond is redeemed or it stops earning interest (in 30 years). Patriot bonds can be redeemed any time after six months for issue dates of January 2003 and earlier; bonds with issue dates on or after February 1, 2003, can be cashed any time after 12 months. Depending on interest rates, bonds may actually reach face value anywhere between 12 and 17 years. However, a 3-month interest penalty is applied to bonds redeemed before five years. Patriot Bonds can be purchased in person at banks or credit unions, or on the Internet at: http:www.savingsbonds.gov.[3]

7665. Can a child owning Series E or EE bonds elect to include interest?

According to IRS Publication 550, if a child is the owner of an E, EE, or I bond, the election to report interest annually may be made by the child or by the parent. The choice is made by filing a return showing all the interest earned through the year and stating that the child is electing to report interest each year. The child then does not have to file another return until he or she has enough gross income during a year to require filing.

A child could elect to change from annual to deferred reporting under Revenue Procedure 89-46. This provision is not included in the current revenue procedure governing such elections.[4] However, Publication 550 states that neither the parent nor the child can change the way that interest is reported unless permission from the IRS is requested (in accordance with the procedures outlined in Q 7660). Thus, it appears that a child may make such election. If the election is available, the parent of a child making such an election may sign Form 3115 on behalf of the child. See Q 591 for an explanation of the taxation and filing requirements of children under age 14.

7666. May the interest on Series EE or Series I bonds used to meet education expenses be excluded from income?

Subject to certain limitations and phaseout rules, interest on *qualified United States savings bonds* may be excluded from gross income to the extent that the proceeds are used to pay *qualified*

1. Rev. Rul. 55-278, 1955-1 CB 471.
2. Rev. Rul. 68-61, 1968-1 CB 346.
3. See Treasury Press Release, Treasury Department Unveils Patriot Bond on 3-Month Anniversary of September 11 Attacks (December 22, 2001).
4. See Rev. Proc. 2002-9, 2002-1 CB 327.

higher education expenses during the taxable year in which the redemption occurs. The exclusion is available only to taxpayers whose *modified adjusted gross income* falls within certain ranges.[1]

The special tax benefits available for education savings with Series EE bonds also apply to Series I (inflation-indexed) savings bonds, provided the requirements set forth below are satisfied.[2] For the treatment of inflation-indexed savings bonds, see Q 7670.

Definitions

Qualified United States savings bonds are any United States savings bonds issued (i) after 1989, (ii) to an individual who has attained age 24 before the date of issuance.[3] The "date of issuance" is the first day of the month the bonds are purchased; therefore, a purchaser who has just reached the age of 24 and wishes to take advantage of the exclusion should purchase the bonds in the month following his or her birthday.[4]

Qualified higher education expenses are tuition and fees required for enrollment or attendance at an eligible educational institution or certain vocational education schools. Qualified higher education expenses do not include amounts by which educational fees are reduced by items such as scholarships, grants, employer provided educational assistance, or other amounts that reduce tuition. The term also does not include expenses with respect to any course or other education involving sports, games, or hobbies other than as part of a degree program. The IRC specifies "tuition and fees required for enrollment or attendance … at an eligible educational institution;" the term does not include expenses incurred for room and board or travel expenses to and from college.[5]

Qualified higher education expenses include any contribution to a qualified tuition program (formerly known as a qualified *state* tuition program – see Q 595) on behalf of a designated beneficiary or to a Coverdell Education Savings Account (formerly known as an Education Individual Retirement Account – see Q 592) on behalf of an account beneficiary who is the taxpayer, the taxpayer's spouse, or any dependent with respect to whom the taxpayer is allowed a dependency exemption. See Q 627.[6] For purposes of applying the rules applicable to qualified tuition programs under IRC Section 529, the investment in the contract is not increased because of any portion of the contribution to the program that is not includable in gross income as a qualified higher education expense.[7]

The rules allowing the exclusion of interest on qualified United States savings bonds are coordinated with the American Opportunity and Lifetime Learning Credits (see Q 646). Generally, the amount of the qualified higher education expenses otherwise taken into account under IRC Section 135(a) with respect to the education of an individual is reduced by the amount of the qualified higher education expenses taken into account in determining the credit

1. IRC Sec. 135.
2. See 31 CFR §359.66.
3. IRC Sec. 135(c)(1).
4. Notice 90-7, 1990-1 CB 304.
5. IRC Secs. 135(c), 135(d); see Instructions to Form 8815.
6. IRC Sec. 135(c)(2)(C).
7. IRC Sec. 135(c)(2)(C).

allowable to the taxpayer or any other person under the rules for the American Opportunity and Lifetime Learning credits with respect to qualified higher education expenses. Likewise, the rules allowing the exclusion of interest on qualified United States savings bonds are also coordinated with the amounts taken into account in determining the exclusions for qualified tuition programs (see Q 595) and Coverdell Education Savings Account distributions. See Q 592.[1] The above amounts are reduced before the application of the interest limitation and phaseout rules (see below).

Modified adjusted gross income refers to adjusted gross income (AGI) determined without regard to this exclusion and without regard to IRC Sections 137 (exclusions for qualified adoption expenses), 221 (deduction for student loan interest), 222 (deduction for higher education expenses, which applies to years ending on or before December 31, 2013), 911, 931, and 933 (the last three sections providing exclusions of foreign earned income or income earned in certain possessions of the United States), but determined *after* application of IRC Sections 86 (partial inclusion of Social Security and railroad retirement benefits), 469 (adjustments with respect to limitations of passive activity losses and credits), and 219 (adjustments for contributions to IRAs and SEPs).[2]

7667. What are the limitations and phaseout rules for excluding interest on Series EE or Series I bonds used to meet education expenses?

If the aggregate proceeds of the bond exceed the amount of expenses paid, the amount of the exclusion is limited to an "applicable fraction" of the interest otherwise excludable. Essentially, this calculation simply reduces the amount of excludable interest pro rata, based on the proportion of educational expenses to redemption amounts. The numerator of the "applicable fraction" is the amount of expenses paid; the denominator is the aggregate proceeds redeemed. For example, a taxpayer whose Series EE bonds have reached maturity may exclude the amount of redemption, up to the amount of fees paid; generally, half of any excess bond proceeds will be treated as taxable interest and the other half as a return of principal. If the qualified education expenses equal or exceed the proceeds of the redemption, this limitation does not apply.[3]

An additional limitation is imposed by means of a phase-out rule, designed to confine the tax benefit to lower and middle income taxpayers. The exclusion is phased out beginning at the following levels of modified adjusted gross income in the 2014 tax year; single or head of household – $76,000; married filing jointly – $113,950. The range over which the phaseout occurs is $15,000 (single) or $30,000 (joint return); thus the exclusion is fully phased out at $91,000 for single filers, or $143,950 for married individuals filing jointly.[4] (The exclusion is not available to married taxpayers filing separately.) The income levels at which the phase-out begins are indexed for inflation and rounded to the nearest $50.[5]

1. IRC Sec. 135(d)(2).
2. IRC Sec. 135(c)(4).
3. IRC Sec. 135(b)(1).
4. Rev. Proc. 2013-35, 2013-47 IRB 537.
5. IRC Sec. 135 (b)(2)(B).

The phaseout amount for tax years beginning in 2014 is calculated as follows:

1. A fraction is determined as follows: (a) the numerator is the excess of the taxpayer's modified adjusted gross income for 2014 over $76,000 (single or head of household) or $113,950 (married filing jointly); (b) the denominator is $15,000 (single or head of household), or $30,000 (joint return). For example, for a single or head of household taxpayer with modified adjusted gross income of $81,000 the ratio would be $5,000 to $15,000, or one-third.

2. The amount otherwise excludable is reduced by that proportion. In the example above, an otherwise permitted exclusion of $12,000 would be reduced by one-third, to $8,000.

The operation of both limitations may be seen in the following example:

Example: Mr. and Mrs. Mabry pay $18,000 in tuition expenses and redeem savings bonds of $20,000 in 2014. They file jointly and their modified adjusted gross income is $123,950.

Exclusion limitation: Of the $20,000 redemption amount, assume that $10,000 is return of principal and $10,000 is interest. Since less than $20,000 was spent on tuition, the exclusion is limited to the amount that represents the proportion of tuition payments to redemption proceeds. The applicable fraction is $18,000/$20,000. Thus, $9,000 of the $10,000 interest is *potentially* excludable and $1,000 would be taxed as ordinary income.

Phaseout amount: The threshold amount in 2014 for the phase-out of the exclusion is $113,950 (joint return), and their $123,950 modified adjusted gross income is $10,000 over that amount. The ratio of $10,000 to $30,000 is one-third, therefore their *otherwise excludable* interest ($9,000) is reduced by one-third, leaving $6,000 that may be excluded from income.

There are several additional rules governing the savings bond exclusion and limiting the potential for abuse of it. The taxpayer must be the original and sole owner of the bond (or own it jointly with his spouse);[1] a bond purchased from another individual will not qualify for the exclusion. The taxpayer purchasing the bond must have attained the age of 24 by the date of issuance. (This rule prevents savings bonds that are purchased in a child's name to avoid the "kiddie tax" from obtaining preferred treatment when redeemed.) The tuition expenses must be for the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer (with respect to whom he can claim a dependency exemption). The exclusion is not available for bonds obtained as part of a tax-free rollover of Series E savings bonds into Series EE bonds.[2]

7668. How is interest on a Series E or EE bond taxed after the death of the owner?

An executor or administrator may make an election on behalf of a decedent (who has not previously elected) to include all interest in the decedent's final income tax return.[3] If the decedent or the decedent's representative had not elected to include interest in the decedent's gross income annually, all interest earned before and after death is income to the estate or other

1. Conference Committee Report, TAMRA '88.
2. Conference Committee Report, TAMRA '88.
3. Rev. Rul. 68-145, 1968-1 CB 203; Rev. Rul. 79-409, 1979-2 CB 208.

beneficiary receiving the bond, either on the election to include interest annually or on redemption, final maturity, or disposal of the bond. Either may defer reporting or elect to report just as any owner. See Q 7660.

Unreported interest earned on E and EE bonds up to the date of death and unreported interest that was part of the consideration for H and HH bonds held at death are income in respect of a decedent.[1] The person who eventually includes the deferred interest in income may take a deduction in the year he or she reports the interest for any estate tax attributable to the income in respect of a decedent. See Q 636.[2] The Service has ruled that in determining the fair market value of Series E savings bonds for estate tax purposes, the estate should not calculate a discount for lack of marketability for the income taxes due on the interest that accrued on the bonds from the date of purchase to the date of maturity.[3]

Like the owner of any other E or EE bond, the owner of E and EE bonds acquired from a decedent could exchange them for Series HH bonds (or H bonds before 1980 – but see *Editor's Note*, below) without recognition of unreported interest.[4] However, the interest must be included in income on disposal, redemption, or final maturity of the H or HH bonds received in the exchange, or on the election of the owner to report annually interest on E and EE bonds. (*Editor's Note*: The Bureau of the Public Debt stopped offering Series HH Savings Bonds to the public after August 31, 2004. HH bonds issued through August 2004 will continue to earn interest until they reach final maturity 20 years after issue.[5])

The Service privately ruled that: (1) the distribution of Series E and Series HH savings bonds from a decedent's estate to several tax-exempt organizations did not result in the recognition of income by the estate; (2) the accrued interest attributable to the bonds would be includable in the gross income of the exempt organizations in the year in which the bonds were disposed of, redeemed, or reached maturity; and (3) assuming that the organizations continued their exempt status, the accrued interest would be exempt when recognized by the organizations.[6]

7669. How is the owner of Series H or HH bonds taxed?

Editor's Note: The Bureau of the Public Debt stopped offering Series HH Savings Bonds to the public after August 31, 2004. HH bonds issued through August 2004 will continue to earn interest until they reach final maturity 20 years after issue.[7]

Series H and HH bonds are interest-paying United States savings bonds. Interest is paid by check semiannually, and the amounts paid in a year are included in gross income.[8] The bonds are nontransferable. Interest received on H/HH bonds is subject to all federal taxes, and the

1. See Let. Rul. 9024016.
2. See Treas. Regs. §§1.691(a)-2(b) Ex. 3, 1.691(b)-1(a); Rev. Rul. 64-104, 1964-1 CB 223.
3. See TAM 200303010.
4. Rev. Rul. 64-104, above.
5. See Press Release (2-18-2004), at: www.publicdebt.treas.gov/com/comtdhhw.htm.
6. Let. Rul 9845026.
7. See Press Release (2-18-2004), at: www.publicdebt.treas.gov/com/comtdhhw.htm.
8. 31 CFR §352.2(e)(1)(i).

bonds are subject to federal and state estate, gift, inheritance, or other excise taxes but not to state or local taxes on principal or interest.[1]

If H or HH bonds were received in exchange for E or EE bonds on which reporting of interest was deferred, the owner may continue to defer reporting the interest accrued on the E or EE bonds exchanged until the year in which the H or HH bonds received in the exchange reach final maturity, are redeemed, or are otherwise disposed of. At that time, the amount of unreported interest on the E or EE bonds that was not recognized at the time of the exchange must be reported as interest.[2] HH bonds bear a legend showing how much of the issue price represents interest on the securities exchanged. The owner of Series H or HH bonds received in exchange for E or EE bonds on which reporting was deferred may elect to report the past increases in redemption value of the E or EE bonds. The election would also apply to any other E or EE bonds or H or HH bonds owned or thereafter acquired, unless the Service permits a change in the owner's method of reporting.[3]

The Service privately ruled that: (1) the distribution of Series E and Series HH savings bonds from a decedent's estate to several tax-exempt organizations did not result in the recognition of income by the estate; (2) the accrued interest attributable to the bonds would be includable in the gross income of the exempt organizations in the year in which the bonds were disposed of, redeemed, or reached maturity; and (3) assuming that the organizations continued their exempt status, the accrued interest would be exempt when recognized by the organizations.[4]

7670. How is the owner of Series I bonds taxed?

Between 1998 and January 1, 2012, the Treasury Department offered a type of savings bond that offered inflation-adjusted interest rates. Series I (inflation-indexed) savings bonds were sold at par value (face amount) in denominations ranging from $50 to $10,000.[5] Prior to January 1, 2012, an individual could purchase no more than $10,000 in Series I bonds during any calendar year.[6] The difference between the purchase price and the redemption value is taxable interest, which is payable when the bond is redeemed or finally matures.[7] Series I savings bonds mature in 30 years.[8]

Series I savings bonds accrue earnings based on *both* a fixed rate of return *and* the semiannual inflation rate.[9] A single rate is constructed to reflect the combined effects of the two rates.[10] The following example demonstrates how the *composite earnings rate* is determined:

> *Example*: The 4.60% composite earnings rate for Series I savings bonds bought from May through October 2011 applied for the first six months after their issue. The earnings rate combined the fixed rate,

1. 31 CFR §352.10.
2. 31 CFR §352.7(g).
3. Rev. Rul. 64-89, 1964-1 (part 1) CB 172.
4. Let. Rul 9845026.
5. 31 CFR §359.25.
6. 31 CFR §359.29.
7. 31 CFR §§359.17, 359.39.
8. 31 CFR §359.5.
9. 31 CFR §§359.8, 359.10, 359.11.
10. 31 CFR §§359.8, 359.13.

then 0, with the 2.30% semiannual inflation rate (as measured by the Consumer Price Index for all Urban Consumers (CPI-CU)).[1]

The formula for computing the composite rate is:

Composite rate = [Fixed rate + (2 x semiannual inflation rate) + (fixed rate x semiannual inflation rate)]

For 2011, the composite rate was calculated as follows:

Composite rate = $[0 + (2 \times 0.0230) + (0 \times 0.0230)]$

Composite rate = $[0 + 0.0460 + 0]$

Composite rate = 0.0460

Composite rate = 4.60%

The fixed rate of return, applicable at the time a Series I savings bond was issued, will apply to the bond throughout its 30-year life.[2] The semiannual inflation rate, announced each May and November, will be reflected in a Series I savings bond's value beginning on that bond's next semiannual interest period following the announcement.[3] In general, a bond's composite rate will be higher than its fixed rate if the semiannual inflation rate reflects any inflation. In other words, inflation will cause a bond to earn additional interest. Likewise, a bond's composite rate will be lower than its fixed rate if the semiannual inflation rate reflects any deflation. Deflation will cause a bond to increase in value slowly, or not increase in value at all. However, even if deflation becomes so great that it would reduce the composite rate to below zero, the Treasury will not allow the value of a bond to decrease from its most recent redemption value.[4]

A Series I savings bond may be redeemed any time after six months for issue dates of January 2003 and earlier. Bonds with issue dates on or after February 1, 2003, can be cashed any time after 12 months. A bond redeemed less than five years from the date of issue will be subject to a 3-month interest penalty.[5] Tables of redemption values are made available in various formats and media, including the Internet (www.savingsbonds.gov).[6] The bonds have an interest paying life of 30 years after the date of issue, and cease to increase in value as of that date.[7]

Interest earned on Series I savings bonds is subject to all federal taxes (unless it qualifies for the exclusion described in Q 7666), and the bonds are subject to federal and state estate, inheritance, gift, or other excise taxes, but not state or local taxes on principal or interest.[8]

Interest earned on Series I savings bonds is includable on federal income tax returns in the same way as Series EE bonds. See Q 7660.[9] In general, owners may defer reporting the

1. See 31 CFR §359.14. See also "I Savings Bonds Rates & Terms" at: http://www.treasurydirect.gov/indiv/research/indepth/ibonds/res_ibonds_iratesandterms.htm.
2. 31 CFR §359.10.
3. 31 CFR §§359.11, 359.15.
4. 31 CFR §359.12; see also U.S. Treasury Department, *Series I Bonds: Information Statement*, p. 6.
5. 31 CFR §§359.6, 359.7.
6. 31 CFR §359.40
7. See "I Savings Bonds Rates & Terms" at: http://www.treasurydirect.gov.
8. Appendix D to Part 359.
9. See Appendix D to Part 359.

increment for federal income tax purposes until: (i) they redeem the bonds, (ii) the bonds cease earning interest after 30 years, or (iii) the bonds are otherwise disposed of, whichever is earlier.[1] However, an owner may elect to accrue the increment each year it is earned.[2] If an investor takes no action, the gain is deferred until the first of the three events described above occurs.[3] The increase in value will be includable in income annually *only* if an investor affirmatively acts by making such an election.[4]

The special tax benefits available for education savings with Series EE bonds also apply to Series I savings bonds.[5] See Q 7666. Essentially, a taxpayer who otherwise satisfies the requirements set forth in IRC Section 135 (see Q 7666) may be able to exclude all or part of the interest earned on Series I savings bonds from income for that tax year.[6]

Series I savings bonds are nontransferable.[7] Although these bonds can be exchanged for Series EE savings bond, they can no longer be exchanged for Series HH savings bonds because the Bureau of Public Debt stopped offering Series HH bonds to the public effective August 31, 2004.

7671. What is a "Ginnie Mae" mortgage backed pass-through certificate?

A Ginnie Mae pass-through certificate represents ownership of a proportionate interest in a fixed pool of mortgages insured or guaranteed by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Department of Agriculture's Rural Housing Service (RHS), and the Department of Housing and Urban Development's Office of Public and Indian Housing (PIH). The mortgages in the pool have the same interest rate, term to maturity, and type of dwelling. The certificates are generally issued by a mortgage banker or savings and loan association and are secured by the pool of mortgages that have been placed by the issuer with a bank custodian. They call for payment by the issuer of specified monthly installments based on the amortization schedules of the mortgages in the pool. In addition, the certificates provide for payment of a proportionate share of prepayments or other early recoveries of principal. An amount is withheld each month by the issuer to discharge the certificate holder's obligation to pay servicing, custodian, and guarantee fees. Pass-through certificates may be either "fully modified" or "straight."

Timely payment of the principal and interest, *whether or not collected*, is guaranteed to the fully modified pass-through certificate holder by the Government National Mortgage Association (GNMA, or "Ginnie Mae"). Straight pass-through certificates provide for the payment by the issuer of a proportionate share of proceeds, *as collected*, on the pool of mortgages, less servicing fees and other costs. Straight pass-through certificates are guaranteed by GNMA only as to proper servicing of the mortgages by the issuer (i.e., payment of interest and principal actually collected or collectible through due diligence).

1. Appendix D to Part 359.
2. Appendix D to Part 359.
3. Appendix D to Part 359.
4. Appendix D to Part 359.
5. 31 CFR §359.66.
6. 31 CFR §359.66.
7. 31 CFR §§360.15, 360.16.

The full faith and credit of the United States is pledged to the payment of all amounts guaranteed by GNMA.[1] Certificates are issued in registered form and are fully transferable and assignable. They are marketable in the secondary market. They are available in minimum denominations of $25,000 ($1 thereafter) and may be available for less in the secondary market. The maximum maturity is 30 years; however, experience has shown that the average life is shorter. If all certificate holders and the issuer agree, the pool arrangement may be terminated at any time prior to the final maturity date.

Similar mortgage backed pass-through certificates are issued and guaranteed by "Fannie Mae" (Federal National Mortgage Association or FNMA), but are not backed by the full faith and credit of the United States.

7672. How is the monthly payment on Ginnie Mae mortgage backed pass-through certificates taxed?

Payments on pass-through certificates to certificate holders are made monthly. Each payment represents part interest and part principal (i.e., payments on the underlying portfolio of mortgages passed through to certificate holders). The issuer provides each certificate holder with a monthly statement indicating which part of the distribution represents scheduled principal amortization, which part is interest, and which part represents unscheduled collection of principal. Interest and other items of income, including prepayment penalties, assumption fees, and late payment charges, must be included in gross income in the year received. Principal payments are tax free to the extent they represent recovery of capital.[2] To the extent they represent discount on purchase of the mortgages, they must be included as ordinary income; as owners of undivided interests in the entire pool, pass-through certificate owners must include as ordinary income their ratable shares of any discount income realized on purchase of each of the mortgages in the pool. Discount on mortgages that are taxable obligations of corporations or governments or their political subdivisions, is included in income as original issue discount under the rules discussed in Q 7635 to Q 7638.[3]

Income from Ginnie Mae certificates is not exempt from state taxation despite the pledging of the full faith and credit of the United States on all amounts guaranteed by the GNMA because the government is a guarantor, not an obligor, of the instruments.[4]

Amounts withheld by the issuer of the certificate to pay servicing, custodian, and guarantee fees are expenses incurred for the production of income. (See Q 7948 for an explanation of the rules governing deduction of such expenses by pass-through entities.) Certificate holders may amortize their proportionate share of any premium paid to acquire mortgages under rules applicable to corporate interest-bearing bonds (see Q 7639).[5]

1. 8 USC §306(g).
2. Rev. Rul. 84-10, 1984-1 CB 155; Rev. Rul. 70-545, 1970-2 CB 7.
3. Rev. Rul. 84-10, above; Rev. Rul. 74-169, 1974-1 CB 147; Rev. Rul. 70-544, 1970-2 CB 6.
4. *Rockford Life Ins. v. Illinois Dept. of Rev.*, 482 US 182 (1987).
5. Rev. Rul. 84-10, above.

7673. What is a "REMIC?"

A REMIC is a "real estate mortgage investment conduit." In general, a REMIC is a fixed pool of real estate mortgages that issues multiple classes of securities backed by the mortgages and that has elected to be taxed as a REMIC. It can issue several different classes of "regular interests" and must issue one (and only one) class of "residual interests."[1] A regular interest is a debt obligation (or is treated as one) and a "residual interest" participates in the income or loss of the REMIC.[2] A REMIC is not treated as a separate taxable entity (unless it engages in certain prohibited transactions); instead, the income is taxable to the interest holders as explained in Q 7674.[3]

Generally, entities that do not qualify as REMICs, but that issue multiple maturity debt obligations, the payments on which are related to payments on the mortgages and other obligations held by the entity, are classified as Taxable Mortgage Pools (TMPs).[4] (Domestic building and loan associations are not considered TMPs.) TMPs are taxed as corporations.[5]

7674. What is a "regular interest" issued by a REMIC? How is the owner of a regular interest taxed?

As a general rule, REMICs issue several classes of "regular" interests and a single class of "residual interests." (See Q 7675 for a discussion of "residual interests.") Regular interests are subject to federal income tax under the following rules.

An interest in a REMIC is a regular interest if it (1) was issued as a designated regular interest on the "startup day" selected by the REMIC, (2) unconditionally entitles the holder to a specified principal amount, and (3) provides for interest payments (if any) that (a) are based on a fixed rate, or, to the extent provided in regulations, at a variable rate, or (b) consist of a specified, unvarying portion of the interest payments on qualified mortgages.[6] See Notice 93-112 for the Service's acceptance of a floating rate as a variable rate.[7]

Under regulations effective for most obligations issued on or after April 4, 1994, a variable rate includes a qualified floating rate as defined in Treasury Regulation Section 1.1275-5(b)(1). In addition, a rate equal to the highest, lowest, or average of two or more qualified floating rates is a variable rate for purposes of IRC Section 860G.

A REMIC may issue a regular interest that bears interest that can be expressed as a percentage of the interest payable on a specified portion of a regular interest acquired from another REMIC (sometimes called a specified portion regular interest or an "Interest Only" interest or "IO"). The Treasury Department and the Service are considering whether to issue regulations with respect to the tax treatment of REMIC IOs for issuers and initial- and secondary-market

1. IRC Sec. 860D.
2. IRC Secs. 860B, 860C.
3. IRC Secs. 860A, 860F(a)(1).
4. IRC Sec. 7701(i)(2); Treas. Reg. §301.7701(i)-1(b).
5. IRC Sec. 7701(i)(1).
6. IRC Sec. 860G(a).
7. 1993-1 CB 298.

purchasers. An advance notice of proposed rulemaking was released in 2004 regarding the proper timing of income or deduction attributable to an "interest only" regular interest in a REMIC. The advance notice provided additional background information and set forth summary descriptions of possible approaches to the pertinent issues.[1] Nothing has yet come of this project, however.

The timing (but not the amount) of the principal payment may be contingent on the extent of prepayment on mortgages and the amount of income from permitted investments.[2] No minimum specified principal amount is required; it may be zero.[3]

Similar requirements apply if the interest is in the form of stock, a partnership interest, interest in a trust, or other form permitted under state law. If an interest is not in the form of debt, it must entitle the holder to a specified amount (even if it is zero) that would, if it were issued in debt form, be identified as the principal amount of the debt.[4]

A REMIC may issue regular interests that are subordinated to other classes of regular interests, which bear all or a disproportionate share of losses or expenses from cash flow shortfalls, such as losses from defaults or delinquencies on mortgages or other permitted investments.[5]

The Service has ruled that, in the event payments received from certain pre-existing interests were insufficient to distribute interest at the applicable stated rate on interests in a newly formed REMIC, a "funds-available" cap would not prevent the new interests from qualifying as regular interests under IRC Section 860G.[6]

Generally, holders of regular interests are taxed as if the interest were a debt instrument, except that holders must account for income from the interest on the accrual method (regardless of the accounting method otherwise used by the holder).[7] Periodic payments of interest (or similar amounts) are treated as accruing pro rata between interest payment dates. Original issue discount on regular interests is includable as it accrues. Special rules apply to the determination of original issue discount on regular interests.[8] For proposed regulations issued in 2004 addressing the special rule for accruing original issue discount on certain REMIC regular interests, which provide for delayed payment periods of fewer than 32 days, see Proposed Treasury Regulation Section 1.1275-2(m); REG-108637-03.[9]

The IRC prohibits (with some exceptions) the indirect deduction through pass-through entities of amounts that would not be allowable as a deduction if paid or incurred directly by an individual.[10] Under some circumstances (e.g., if the REMIC is substantially similar to an

1. See REG-106679-04, 69 Fed. Reg. 52212 (8-25-2004).
2. IRC Sec. 860G(a)(1). See Treas. Reg. §1.860G-1(a)(5).
3. Treas. Reg. §1.860G-1(a)(2)(iv).
4. Treas. Reg. §1.860G-1(b)(4).
5. Treas. Reg. §1.860G-1(b)(3)(iii).
6. Let. Rul. 199920030.
7. IRC Sec. 860B.
8. IRC Sec. 1272(a)(6).
9. 69 Fed. Reg. 52217 (8-25-2004).
10. IRC Sec. 67(c).

investment trust) holders of regular interests may be required under IRC Section 67(c) and regulations thereunder to include in income as interest an allocable share of certain investment expenses of the REMIC. The amount may be deducted as a miscellaneous itemized deduction if the holder itemizes deductions; however, aggregate miscellaneous deductions are subject to a 2 percent floor.[1] No increase in basis is allowed for the amount passed through as miscellaneous expense even though it is included in income.[2] See Q 631 regarding the treatment of miscellaneous itemized deductions.

The REMIC is required to report to regular interest holders amounts includable as interest and original discount and the allocable share of expenses.[3] However, under regulations effective June 16, 2000, the requirement that REMIC issuers set forth certain "legending" information on the face of certificates when issued (i.e., the total amount of original issue discount on the instruments, the issue date, the rate at which interest is payable as of the issue date, and the yield to maturity) has been eliminated.[4]

On disposition, gain is ordinary income to the extent that it does not exceed the excess (if any) of (1) the interest the holder would have included in gross income if the yield on the regular interest were calculated at a rate of 110 percent of the applicable federal rate as of the beginning of the taxpayer's holding period, over (2) the amount of interest actually includable in gross income by the taxpayer prior to disposition.[5]

Regular interests may be treated as market discount bonds (see Q 7628) if the revised issue price (within the meaning of IRC Section 1278) exceeds the holder's basis in the interest. Market premium on a regular interest can be amortized currently. See Q 7639.

FASIT transfers to REMICS. The FASIT rules have been repealed. See Q 7678.[6] The amendments are generally effective on January 1, 2005.[7] The definitions of REMIC regular interests, qualified mortgages, and permitted investments have been modified so that certain types of real estate loans and loan pools can be transferred to, or purchased by, a REMIC. According to the Conference Committee Report, modifications to the present-law REMIC rules are intended to permit the use of REMICS by taxpayers that have relied on FASITs to securitize certain obligations secured by interests in real property.[8]

7675. What is a "residual interest" issued by a REMIC? How is the owner of a residual interest taxed?

In general, a residual interest is any interest in a REMIC, other than a regular interest, that is issued on the startup day and is designated as a residual interest.[9] However, there may

1. Temp. Treas. Reg. §1.67-3T(b)(3).
2. Temp. Treas. Reg. §1.67-3T(b)(5).
3. Treas. Reg. §1.67-3(f); Treas. Reg. §1.6049-7(f).
4. TD 8888, 65 Fed. Reg. 37701 (6-16-2000); Treas. Reg. §1.6049-7(g), withdrawn.
5. IRC Sec. 860B(c).
6. IRC Secs. 860H, 860I, 860J, 860K, 860L, as repealed by Act. Sec. 835(a), AJCA 2004.
7. Act. Sec. 835(c)(1), AJCA 2004.
8. H.R. Conf. Rep. No. 108-755 (AJCA 2004). See IRC Secs. 860G(a)(1), 860G(a)(3), 860G(a)(7), as amended by AJCA 2004.
9. IRC Sec. 860G(a)(2).

be only one class of such interests and any distributions with respect to such interests must be pro rata.[1]

The holder of a residual interest takes into account his daily portion of the taxable income or net loss of the REMIC for each day that he or she held the interest during the taxable year.[2] Any reasonable convention may be used to determine the holder's daily portion of income or loss.[3] This amount is treated as ordinary income or loss.[4] Such income in excess of daily accruals of income on the issue price at 120 percent of the long-term federal rate is called "excess inclusions," and a holder of a residual interest can in no event have a taxable income of less than his or her excess inclusions. In other words, they cannot be offset by any deductions.[5]

In addition, a REMIC must allocate to certain residual interest holders each calendar quarter a proportionate share of investment expenses paid or accrued for the quarter for which a deduction is allowed under IRC Section 212 to the REMIC: these holders are individuals, any other persons (such as a trust or estate) that compute taxable income in the same manner as an individual, and certain pass-through entities (such as partnerships, S corporations, and grantor trusts) having as a partner, shareholder, beneficiary, participant, or interest holder an individual, a person who computes taxable income in the same manner as an individual, or a pass-through entity. Such a residual interest holder must include in income his or her allocable share of these expenses and may deduct them as miscellaneous itemized expenses subject to the 2 percent floor.[6]

Distributions from a REMIC are not included in gross income by the holder unless they exceed his or her adjusted basis in the interest. To the extent distributions exceed the holder's basis, the excess is treated as gain from sale of the residual interest.[7] The amount of net loss that may be taken into account by the holder with respect to any calendar quarter is limited to the adjusted basis of the interest as of the close of the quarter. Disallowed loss may be carried over indefinitely in succeeding quarters.[8]

The adjusted basis of a residual interest is increased by the amount of taxable income of the REMIC taken into account by the holder; it is decreased (not below zero) by the amount of distributions and by any net loss taken into account.[9] However, no increase in the holder's basis is allowed for the amount of miscellaneous expenses allocated to the holder and included in his or her income.[10]

With certain exceptions, a REMIC's taxable income, for purposes of determining the amount includable by holders of residual interests, is determined in the same manner as for individuals, using a calendar year and using the accrual method of accounting.[11]

1. IRC Sec. 860D(a).
2. IRC Sec. 860C(a).
3. Treas. Reg. §1.860C-1(c).
4. IRC Sec. 860C(e).
5. IRC Sec. 860E(a); Treas. Reg. §1.860E-1(a).
6. IRC Sec. 67(c); Temp. Treas. Reg. §1.67-3T(a).
7. IRC Sec. 860C(c).
8. IRC Sec. 860C(e)(2).
9. IRC Sec. 860C(d).
10. Temp. Treas. Reg. §1.67-3T(b)(5).
11. IRC Sec. 860C(b). See Treas. Reg. §1.860C-2.

The Service privately ruled that whether a holder is liable for taxes associated with a noneconomic REMIC residual interest depends on the facts and circumstances associated with the transfer of the interest.[1]

The REMIC is required to provide information quarterly (on Schedule Q) to holders of residual interests regarding their share of income or loss, the amount of excess inclusion, and allocable investment expenses.[2]

For purposes of the wash sale rules (see Q 7535), a residual interest in a REMIC is treated as a security and, except as provided in regulations, such a residual interest and an interest in a "taxable mortgage pool" are treated as substantially identical stock or securities. Furthermore, the 30-day period in the wash sale rules is enlarged to six months in applying it to such interests. (For this purpose, the definition of a taxable mortgage pool is treated as if in effect in tax years beginning after 1986.)[3]

The Service released regulations in 2002 relating to safe harbor transfers of noneconomic REMIC residual interests in REMICs. The regulations provide additional limitations on the circumstances under which transferors may claim safe harbor treatment.[4]

The Service also issued regulations in 2008 relating to income associated with a residual interest in a REMIC that is allocated through certain entities to foreign persons who have invested in those entities.[5]

If a charitable remainder trust (CRT—see Q 7973, Q 7979, and Q 7980) is a partner in a partnership or a shareholder in a real estate investment trust (REIT—see Q 7883), and if the partnership or the REIT has excess inclusion income from holding a residual interest in a REMIC, the Service has ruled that: (1) the excess inclusion income allocated to a CRT is not UBTI to the CRT and, thus, does not affect the CRT's tax exemption for the taxable year; (2) a CRT is a disqualified organization for purposes of IRC Section 860E; and (3) a pass-through entity that has excess inclusion income allocable to a CRT is subject to the pass-through entity tax under IRC Section 860E(e)(6)(A).[6] In a legal memorandum, the Service concluded that, in general, a holder of a residual interest in a REMIC may not offset excess inclusion income by an otherwise allowable charitable contribution deduction.[7]

In 2006, the Service provided interim guidance relating to excess inclusion income of pass-through entities, particularly real estate investment trusts. See Q 7883. The interim guidance applies to excess inclusion income from REMIC residual interests (and REIT taxable mortgage pools), whether received directly or allocated from another pass-through entity.[8]

1. Let. Rul. 200032001.
2. Treas. Reg. §1.67-3(f); Treas. Reg. §1.860F-4(e)(1).
3. IRC Sec. 860F(d).
4. See Treas. Regs. §§1.860E-1(c)(4), 1.860E-1(c)(5) through 1.860E-1(c)(10), 67 Fed. Reg. 47451 (7-19-2002), *superseding* Rev. Proc. 2001-12, 2001-3 CB 335.
5. See TD 9415, 73 Fed. Reg. 40171 (7-14-2008).
6. See Rev. Rul. 2006-58, 2006-2 CB 876.
7. ILM 200850027.
8. See Notice 2006-97, 2006-2 CB 904.

7676. How is excess inclusion income from a REMIC residual interest coordinated with a taxpayer's net operating losses?

Any "excess inclusion" (see Q 7675) for any taxable year is not to be taken into account in determining the amount of any net operating loss (NOL) for the taxable year (i.e., in determining the loss for a "loss year").[1] Any excess inclusion for a taxable year is not to be taken into account in determining taxable income for the taxable year for purposes of the second sentence of IRC Section 172(b)(2).[2]

The Service has ruled that in computing an NOL for the taxable year, no excess inclusion is taken into account. If, during the same taxable year, a taxpayer both recognizes an excess inclusion and incurs an NOL, the excess inclusion may not be offset by the NOL and is not taken into account in determining the amount of the NOL that may be carried to another taxable year.

The Service has further ruled that if an NOL is carried back or carried over to a taxable year in which an excess inclusion is recognized, the excess inclusion cannot be offset by the NOL carryback or carryover, and is not included in the calculation of taxable income for NOL absorption purposes.[3]

7677. What are REMIC inducement fees? How are these fees taxed?

The IRS released regulations relating to the proper timing and source of income from fees received to induce the acquisition of noneconomic residual interests in REMICS. The regulations provide that an inducement fee must be included in income over a period reasonably related to the period during which the applicable REMIC is expected to generate taxable income (or net loss) allocable to the holder of the noneconomic residual interest. Under a special rule applicable upon disposition of a residual interest, if any portion of an inducement fee received with respect to becoming the holder of a noneconomic residual interest has not been recognized in full by the holder as of the time the holder transfers (or otherwise ceases to be the holder for federal income tax purposes) that residual interest in the applicable REMIC, the holder must include the unrecognized portion of the inducement fee in income at that time.

The regulations set forth two safe harbor methods of accounting for inducement fees, and contain a rule that an inducement fee is income from sources within the United States.[4] The Service also released the procedures by which taxpayers can obtain automatic consent to change from any method of accounting for inducement fees to one of the two safe harbor methods.[5] The Service reached a settlement with two entities that purportedly brokered noneconomic residual interests in a manner based on what the IRS perceived to be an overly aggressive interpretation of the tax laws.[6]

1. See IRC Sec. 860E(a)(3)(A).
2. See IRC Sec. 860E(a)(3)(B).
3. Rev. Rul. 2005-68, 2005-2 CB 853.
4. See Treas. Regs. §§1.446-6, 1.860C-1(d), 1.863-1(e), 1.863-1(f), 69 Fed. Reg. 26040 (5-11-2004).
5. See Rev. Proc. 2004-30, 2004-1 CB 950.
6. See IR-2004-97 (7-26-2004).

7678. What is a "FASIT"?

Editor's Note: The FASIT rules have been repealed.[1] (For the underlying reasons triggering the repeal, see H.R. Conf. Rep. No. 108-755 (AJCA 2004).) The amendments are generally effective on January 1, 2005.[2] However, the repeal provision also provides a transition period for existing FASITS, under which the repeal of the FASIT rules generally does not apply to any FASIT in existence on the date of the enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms of issuance.[3] See Q 7674 for modifications to the present-law REMIC rules that permit the use of REMICs by taxpayers that have relied upon FASITs to securitize certain obligations secured by interests in real property.

A *financial asset securitization investment trust* (FASIT) is any entity (1) for which an election to be treated as a FASIT applies for the taxable year, (2) all of the interests in which are regular interests or the ownership interest (as defined in Q 7679), (3) that has only one ownership interest and such ownership interest is held directly by an eligible corporation, (4) "substantially all" (see "substantiality test" below) of the assets of which consist of *permitted assets* as of the close of the third month beginning after the day of its formation and at all times thereafter (except during liquidation), and (5) is not a regulated investment company. See Q 7850.[4]

FASITs are a type of investment instrument that were designed to facilitate the securitization of debt obligations such as credit card receivables, home equity loans, and automobile loans. A *regular interest* in a FASIT may be held by any person; however, if the interest constitutes a *high-yield interest*, it may be held only by another FASIT or an eligible corporation.6 An *ownership interest* may be held only by an eligible corporation. An *eligible corporation* is any non-exempt domestic C corporation other than a RIC, REIT, REMIC, or subchapter T cooperative.[5] See Q 7679 for the definitions of regular interest, high-yield interest, and ownership interest.

For purposes of IRC Section 860L(a)(1)(D), a FASIT meets the "substantiality test" if the aggregate adjusted basis of its assets other than *permitted assets* is less than 1 percent of the aggregate adjusted basis of all its assets.[6] *Permitted assets* that may be held by a FASIT are: (1) cash or cash equivalents;[7] (2) any debt instrument (as defined in IRC Section 1275(a)(1)) under which interest payments (or other similar amounts), if any, at or before maturity meet certain requirements applicable to regular interests in a REMIC (see Q 7674); (3) foreclosure property (as defined in IRC Section 860L(c)(3)[8]); (4) any asset (i) that is an interest rate or foreign currency notional principal contract, letter of credit, insurance, guarantee against payment defaults, or other similar instrument permitted by the Secretary, and (ii) that is reasonably required to guarantee or hedge against the FASIT's risks associated with being the obligor on

1. IRC Secs. 860H, 860I, 860J, 860K, 860L, as repealed by AJCA 2004 Sec. 835(a).
2. AJCA 2004 Sec. 835(c)(1).
3. See AJCA 2004 Sec. 835(c)(2).
4. IRC Sec. 860L(a)(1).
5. IRC Sec. 860L(a)(2); Prop. Treas. Reg. §1.860H-1(a); Ann. 96-121, above.
6. See Prop. Treas. Reg. §1.860H-2(a).
7. See Prop. Treas. Reg. §1.860H-2(c).
8. See Prop. Treas. Reg. §1.860H-2(f).

interests issued by the FASIT[1]); (5) contract rights to acquire debt instruments described under (2) above, or assets described under (4) above[2]); (6) any regular interest in another FASIT; and (7) any regular interest in a REMIC.[3] Special rules apply for contracts or agreements in the nature of a line of credit.[4] *Permitted assets* do not include any debt instrument issued by the holder of the ownership interest or a related person other than a cash equivalent, or any direct or indirect interest in such a debt instrument.[5]

A *permitted debt instrument* is: (1) a fixed rate debt instrument, including a debt instrument having more than one payment schedule for which a single yield can be determined under Treasury Regulation Sections 1.1272-1(c) or 1.1272-1(d); (2) a variable rate debt instrument within the meaning of Treasury Regulation Section 1.1272-5, if the debt instrument provides for interest at a qualified floating rate within the meaning of Treasury Regulation Section 1.1275-5(b); (3) a REMIC regular interest; (4) a FASIT regular interest (including a FASIT regular interest issued by another FASIT in which the owner (or a related person) holds an ownership interest); (5) an inflation-indexed debt instrument as defined in Treasury Regulation Section 1.1275-7; (6) any receivable generated through an extension of credit under a revolving credit agreement (such as a credit card account; (7) a stripped bond or stripped coupon (as defined in IRC Sections 1286(e)(2) and 1286(e)(3)), if the debt instrument from which the stripped bond or stripped coupon is created is described in (1) - (6), above; and (8) a certificate of trust representing a beneficial ownership interest in a debt instrument described in items (1) - (7), above.[6] Special rules apply to short-term instruments issued by the owner or a related person.[7] Debt instruments that are not permitted assets include: (1) an equity-linked debt instrument (e.g., a debt instrument convertible into stock); (2) a defaulted debt instrument; (3) owner debt; (4) certain owner-guaranteed debt; (5) a debt instrument linked to the owner's credit; (6) partial interests in non-permitted debt instruments; and (7) certain foreign debt subject to withholding tax.[8]

Once an entity elected to be treated as a FASIT, the election applied for all subsequent taxable years unless revoked with the consent of the Service. In the event the entity ceases to be a FASIT, it will not be treated as a FASIT after the date of cessation unless the termination is inadvertent and adjustments are made to restore the entity to FASIT status.[9]

Under proposed regulations issued in 2000, never to be finalized, in the event of cessation, the FASIT owner is treated as disposing of the FASIT's assets for their fair market value in a prohibited transaction. Gain on this deemed distribution is subject to the prohibited transactions tax. Any loss is disallowed.[10] The owner must recognize cancellation of indebtedness income in

1. See Prop. Treas. Regs. §§1.860H-2(d) and 1.860H-2(e).
2. See Prop. Treas. Reg. §1.860H-2(h).
3. IRC Sec. 860L(c).
4. Prop. Treas. Reg. §1.860H-2(g).
5. IRC Sec. 860L(c).
6. Prop. Treas. Reg. §1.860H-2(b)(1)(i)-(viii).
7. See Prop. Treas. Reg. §1.860H-2(b)(2).
8. Prop. Treas. Reg. §1.860H-2(b)(3)(i)-(vii).
9. IRC Sec. 860L(a); Prop. Treas. Reg. §1.860H-3(a).
10. See Prop. Treas. Reg. §1.860H-3(c)(2)(i).

an amount equal to the adjusted issue price of the regular interests outstanding immediately before the cessation over the fair market value of those interests immediately before the cessation.[1] Holders of the regular interests are treated as exchanging their FASIT regular interests for interests in the underlying arrangement. Gain must be recognized if a regular interest is exchanged either for an interest not classified as debt or for an interest classified as debt that differs materially either in kind or extent. No loss may be recognized on the exchange.[2] The underlying arrangement is no longer treated as a FASIT and generally is prohibited from being the subject of a new FASIT election. In addition, the underlying arrangement is treated as holding the assets of the terminated FASIT and is classified under general tax principles (e.g., as a corporation or partnership).[3]

A FASIT is not treated as a taxable entity. (However, a penalty is imposed on the holder of the ownership interest if the FASIT engages in certain prohibited transactions.) Instead, the income is taxable to the interest holders as explained in Q 7679.[4]

7679. How is the holder of "regular interests" issued by a FASIT taxed?

Editor's Note: The FASIT rules have been repealed.[5] The amendments are generally effective on January 1, 2005.[6] However, the provision provides a transition period for existing FASITS under which the repeal of the FASIT rules generally does not apply to any FASIT in existence on the date of the enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms of issuance.[7] See Q 7674 for modifications to the present-law REMIC rules that permit the use of REMICs by taxpayers that have relied upon FASITs to securitize certain obligations secured by interests in real property.

A *financial asset securitization investment trust* (FASIT - see Q 7678) may issue one or more classes of "regular interests" and a single "ownership" interest (see Q 7680).[8]

A *regular interest* is any interest that was issued by a FASIT on or after the *startup day* with fixed terms and that was designated as a regular interest if it (1) unconditionally entitles the holder to receive a specified principal amount (or other similar amounts) as described below; (2) provides that interest payments, if any, are based on a fixed rate or, to the extent provided in regulations, at a variable rate; (3) does not have a stated maturity (including options to renew) greater than 30 years, although a longer period may by permitted by regulations; (4) had an *issue price* that did not exceed 125 percent of its stated principal amount; and (5) had a yield to maturity less than the sum of the applicable federal rate for the calendar month in which the obligation was issued plus five percentage points.

1. Prop. Treas. Reg. §1.860H-3(c)(2)(ii).
2. See Prop. Treas. Reg. §1.860H-3(c)(3).
3. See Prop. Treas. Reg. §1.860H-3(c)(1).
4. IRC Secs. 860H(a), 860L(e).
5. IRC Secs. 860H, 860I, 860J, 860K, 860L, as repealed by AJCA 2004 Sec. 835(a). (For the underlying reasons triggering the repeal, see H.R. Conf. Rep. No. 108-755 (AJCA 2004).)
6. AJCA 2004 Sec. 835(c)(1).
7. AJCA 2004 Sec. 835(c)(2).
8. IRC Sec. 860L(a)(1); see Prop. Treas. Reg. §1.860H-1(a).

A regular interest will not fail to meet the first requirement merely because the timing (but not the amount) of the principal payments (or similar amounts) may be contingent on (a) the extent to which payments on debt instruments held by a FASIT are made in advance of anticipated payments and on (b) the amount of income from permitted assets.[1] The term *startup day* means the date designated in the FASIT election as the startup day of the FASIT.[2] The *issue price* of a FASIT regular interest not issued for property was determined under IRC Section 1273(b).[3] Notwithstanding IRC Sections 1273 and 1274, the issue price of a FASIT regular interest issued for property was the fair market value of the regular interest determined as of the issue date.[4]

Generally, a holder of a regular interest is taxed as if the regular interest were a debt instrument, except that a holder must account for income from the interest on an accrual basis (regardless of the accounting method otherwise used by the holder).[5] The holder of a regular interest will not be subject to special rules under IRC Section 163(e)(5) for original issue discount on certain high-yield obligations.[6]

High-Yield Interests

The term *regular interest* may also include any *high-yield interest*. A high-yield interest is one that would meet the definition of a regular interest except that it does not meet one or more of the clauses of requirements (1), (4), or (5) in the definition of regular interests above. Furthermore, an interest that fails to meet requirement (2) above may constitute a high-yield interest if interest payments (or similar amounts), if any, consist of a specified portion of the interest payments on permitted assets (see Q 7678 for a definition of *permitted assets*) and such portion does not vary during the period such interest is outstanding. A high-yield interest can be held only by another FASIT or an *eligible corporation* (defined in Q 7678).[7]

The taxable income of a holder of a high-yield interest may not be less than the sum of (1) the holder's taxable income determined solely with respect to such interests and (2) any excess inclusion (if any) imposed on the holder of a residual interest of a REMIC.[8] Any increase in taxable income for any taxable year that results from the application of the above rule is disregarded in determining the amount of any net operating loss for the taxable year and determining taxable income for purposes of carrybacks and carryforwards of a net operating loss.[9] Similar rules apply to the holders of high-yield interests subject to the alternative minimum tax.[10]

Special rules apply to high-yield interests that are held by *disqualified holders*.[11] A disqualified holder is any holder other than a FASIT or an eligible corporation (as defined in Q 7678).[12]

1. IRC Sec. 860L(b)(1).
2. IRC Sec. 860L(d).
3. Prop. Treas. Reg. §1.860H-4(a)(1).
4. Prop. Treas. Reg. §1.860H-4(a)(2).
5. IRC Sec. 860H(c).
6. IRC Secs. 860H(c)(2), 163(e)(5).
7. IRC Sec. 860L(b)(1)(B)(ii); Ann. 96-121, 1996-47 IRB 12.
8. IRC Secs. 860J(a), 860E(a)(1).
9. IRC Sec. 860J(b).
10. IRC Sec. 860J(c).
11. See IRC Sec. 860K(a); see also Prop. Treas. Reg. §1.860H-4(b)(1).
12. See IRC Secs. 860K(c), 860L(a)(2).

7680. How is the holder of "ownership interests" issued by a FASIT taxed?

Editor's Note: The FASIT rules have been repealed.[1] The amendments are generally effective on January 1, 2005.[2] However, the provision provides a transition period for existing FASITS under which the repeal of the FASIT rules generally does not apply to any FASIT in existence on the date of the enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms of issuance.[3] See Q 7674 for modifications to the present-law REMIC rules that permit the use of REMICs by taxpayers that have relied upon FASITs to securitize certain obligations secured by interests in real property.

An *ownership interest* is defined as any interest issued by the FASIT after the *startup day* (defined in Q 7679) that was designated as an ownership interest and was not a regular interest.[4] A FASIT may have only one ownership interest, which must be directly held by an eligible corporation. See Q 7678.[5]

The following rules are applied in determining the taxable income of the holder of an ownership interest in a FASIT: (1) all assets, liabilities, and items of income, gain, deduction, loss, and credit of a FASIT are treated as those of the ownership interest holder; (2) a constant yield method (including the special rules under IRC Section 1272(a)(6) for accelerated payments) under the accrual method of accounting must be used to determine all interest, acquisition discount, original issue discount, market discount, and premium deductions or adjustments with respect to each debt instrument of the FASIT; (3) no items of income, gain, or deduction allocable to a *prohibited transaction* are taken into account, and (4) any tax-exempt interest accrued by the FASIT is treated as ordinary income of the holder.[6]

For the owner's annual reporting requirements, including the manner in which the items of income, gain, loss, deduction, and credit from permitted transactions and prohibited transactions are to be taken into account separately, see Proposed Treasury Regulation Section 1.860H-6(e). The method of accounting for permitted hedges, and the character of such hedges, are set forth in Proposed Treasury Regulation Section 1.860H-6(c). Rules coordinating the FASIT owner rules with the mark to market provisions are stated in Proposed Treasury Regulation Section 1.860H-6(d). For the rule governing the transfer of an ownership interest, see Proposed Treasury Regulation Section 1.860H-6(g). In early 2001, the Service announced an alternative safe harbor under which the transfer of a FASIT ownership interest is presumed to be accomplished without an intention to impede the assessment or collection of tax.[7]

A *prohibited transaction* means (1) the receipt of any income derived from any asset that is not a permitted asset (as defined in Q 7678) (with certain exceptions), (2) the disposition

1. IRC Secs. 860H, 860I, 860J, 860K, 860L, as repealed by AJCA 2004 Sec. 835(a). (For the underlying reasons triggering the repeal, see H.R. Conf. Rep. No. 108-755 (AJCA 2004).)
2. AJCA 2004 Sec. 835(c)(1).
3. AJCA 2004 Sec. 835(c)(2).
4. IRC Sec. 860L(b)(2).
5. IRC Secs. 860L(a)(C); Prop. Treas. Reg. §1.860H-1(a)(1).
6. IRC Sec. 860H(b); Prop. Treas. Regs. §§1.860H-6(a) and 1.860H-6(b); Ann 96-121, 1996-47 IRB 12.
7. See Rev. Proc. 2001-12, 2001-1 CB 335.

of any permitted asset other than foreclosure property (with certain exceptions), (3) the receipt of any income derived from any loan originated by the FASIT,[1] and (4) the receipt of any income representing a fee or other compensation for services (other than any fee received as compensation for a waiver, amendment, or consent under permitted assets not acquired through foreclosure).[2] The receipt of any income derived from any asset that is not a permitted asset will not constitute a prohibited transaction where income is derived from the disposition of certain former hedge assets or contracts to acquire such assets.[3] Additionally, dispositions of permitted assets that will not constitute a prohibited transaction include certain substitutions of debt instruments to reduce over-collateralization, certain transactions that are excepted from the prohibited transactions penalty under the REMIC rules (see Q 7674), and the complete liquidation of any class of regular interests.[4]

Whether an activity will or will not be presumed to be loan origination is determined under Proposed Treasury Regulation Sections 860L-1(a)(2) and 1.860L-1(a)(3). The proposed regulations provide five safe harbors to limit the scope of the prohibited transaction rules as they relate to loan origination.[5] The distribution to the owner of a debt instrument contributed by the owner, and the transfer to the owner of one debt instrument in exchange for another, are prohibited transactions *if* within 180 days of receiving the debt instrument the owner realizes a gain on the disposition of the instrument to any person regardless of whether the realized gain is recognized.[6] To clarify the application of the distribution rule, the proposed regulations deem a distribution of a debt instrument to be carried out principally to recognize gain if the owner (or a related person) sells the substituted or distributed debt instrument at a gain within 180 days of the substitution or distribution.[7]

The taxable income of a holder of an ownership interest may not be less than the sum of (1) the holder's taxable income determined solely with respect to such interests and (2) any excess inclusion (if any) of a holder of a residual interest of a REMIC.[8] Any increase in taxable income for any taxable year that results from the application of the above rule is disregarded in determining the amount of any net operating loss for the taxable year and determining taxable income for purposes of carrybacks and carryforwards of a net operating loss.[9] Similar rules apply to the holders of an ownership interest subject to the alternative minimum tax.[10]

Gain recognition on property transferred to FASIT. If property is sold or contributed to a FASIT by the holder of the ownership interest (or a related person), gain (but not loss) is recognized by the holder (or related person) in an amount equal to the excess (if any) of the property's value (determined under IRC Section 860I(d)) on the date of sale or contribution over its adjusted

1. See Prop. Treas. Reg. §1.860L-1(a)(1).
2. IRC Sec. 860L(e)(2).
3. IRC Sec. 860L(e)(3)(D); Prop. Treas. Reg. §1.860L-1(d).
4. IRC Sec. 860L(e)(3).
5. See Prop. Treas. Regs. §§1.860L-1(a)(2) and 1.860L-1(a)(4).
6. Prop. Treas. Reg. §1.860L-1(c).
7. See Prop. Treas. Reg. §1.860L-1(c).
8. IRC Secs. 860J(a), 860E(a)(1).
9. IRC Sec. 860J(b).
10. IRC Sec. 860J(c).

basis on such date.[1] If the FASIT acquires property other than from a holder of an ownership interest or related person, the property is treated as having been acquired by the holder of the ownership interest for an amount equal to the FASIT's cost of acquiring such property, and then as having been sold to the FASIT at the value determined under IRC Section 860I(d).[2] An owner (or a related person) does not have to recognize gain under IRC Section 860I on a transfer or pledge of property to a regular interest holder if the owner (or related person) makes the transfer or pledge in a capacity other than as owner (or related person) and the regular interest holder receives the transfer or pledge in a capacity other than regular interest holder.[3]

7681. How is the value of property for gain recognition purposes determined under the FASIT provisions?

Editor's Note: The FASIT rules have been repealed.[4] The amendments are generally effective on January 1, 2005.[5] However, the provision provides a transition period for existing FASITS under which the repeal of the FASIT rules generally does not apply to any FASIT in existence on the date of the enactment to the extent that regular interests issued by the FASIT prior to such date continue to remain outstanding in accordance with their original terms of issuance.[6] See Q 7674 for modifications to the present-law REMIC rules that permit the use of REMICs by taxpayers that have relied upon FASITs to securitize certain obligations secured by interests in real property.

The value of property, for purposes of the FASIT provisions, is determined under special rules set forth in IRC Section 860I(d). In the case of a nonpublicly traded debt instrument, the value is equal to the sum of the present values of the reasonably expected payments under such instrument determined (in the manner provided by regulations prescribed by the Secretary) (1) as of the date of the event resulting in the gain recognition under IRC Section 860I and (2) by using a discount equal to 120 percent of the applicable federal rate (see Q 589), or such other discount rate specified in the regulations, compounded semiannually.[7] Reasonably expected payments on an instrument must be determined in a commercially reasonable manner and may take into account reasonable assumptions concerning early repayments, late payments, non-payments, and loan servicing costs. No other assumptions may be considered.[8] Any assumption used in determining the reasonably expected payments on an instrument must satisfy the consistency test.[9] In addition to the consistency test, the proposed regulations place a ceiling on projected loan servicing costs.[10]

The proposed regulations provide exceptions from the special valuation rules (discussed above) for certain beneficial and stripped interests.[11] The proposed regulations also provide an

1. IRC Sec. 860I(a)(1); Prop. Treas. Reg. §1.860I-1(a)(1); Ann. 96-121, 1996-47 IRB 12.
2. IRC Sec. 860I(a)(2); Prop. Treas. Reg. §1.860I-1(g).
3. Prop. Treas. Reg. §1.860I-1(a)(2).
4. IRC Secs. 860H, 860I, 860J, 860K, 860L, as repealed by AJCA 2004 Sec. 835(a). (For the underlying reasons triggering the repeal, see H.R. Conf. Rep. No. 108-755 (AJCA 2004).)
5. AJCA 2004 Sec. 835(c)(1).
6. AJCA 2004 Sec. 835(c)(2).
7. IRC Sec. 860I(d)(1)(A); see Prop. Treas. Reg. §1.860I-2(a).
8. Prop. Treas. Reg. §1.860I-2(c)(1).
9. See Prop. Treas. Reg. §1.860I-2(c)(2).
10. See Prop. Treas. Reg. §1.860I-2(c)(3).
11. See Prop. Treas. Regs. §§1.860I-2(d)(1) and 1.860I-2(d)(2).

exception for certain debt instruments that are contemporaneously purchased and transferred to the FASIT (i.e., the spot purchase rule). Under this provision, the value of a debt instrument is its cost to the owner if four conditions are met.[1] The special valuation rule for guarantees is set forth in Proposed Treasury Regulation Section 1.860I-2(d)(4).

In the case of any other property (i.e., debt traded on an established securities market), the value is its fair market value.[2] A debt instrument is traded on an established securities market if it is traded on a market described in Treasury Regulation Sections 1.1273-2(f)(2), 1.1273-2(f)(3), or 1.1273-2(f)(4).[3] In the case of revolving loan accounts, each extension of credit (other than the accrual of interest) will be treated as a separate debt instrument, and payments on such extensions of credit having substantially the same terms will be applied to such extensions beginning with the earliest extension.[4]

Gain is determined and recognized immediately before the property is transferred to the FASIT or becomes support property, or in the case of foreclosure property, on the day immediately following the termination of the grace period allowed for foreclosure property.[5]

If property held by the holder of the ownership interest in a FASIT (or by a person related to such holder) supports any regular interest in the FASIT, gain is recognized to the holder or related person in the same manner as if the holder had sold the property (at the value determined under IRC Section 860I(d)) on the earliest date that the property supports such an interest. In addition, the property is treated as held by the FASIT.[6] Support property is defined in Proposed Treasury Regulation Section 1.860I-1(b).

Future regulations were authorized that would have provided for the deferral of gain that would otherwise have been recognized under IRC Section 860I(a) or IRC Section 860I(b) above (but see *Editor's Note*, above).[7]

The basis of any property on which gain is recognized under the FASIT rules is increased by the amount of such gain.[8] Furthermore, the rules governing recognition of gain by FASITs supersede any other nonrecognition provisions (e.g. like-kind exchanges) that might otherwise apply.[9]

For purposes of the FASIT rules, persons are *related* if they meet the definition with respect to individuals described in IRC Section 267(b) or controlled partnerships under IRC Section 707(b), except that in applying IRC Sections 267(b) or 707(b)(1), "20 percent" will be substituted for "50 percent" where applicable (see Q 607).[10] A related person also includes certain persons engaged in trades or businesses under common control.[11]

1. See Prop. Treas. Reg. §1.860I-2(d)(3).
2. IRC Sec. 860I(d)(1)(B).
3. Prop. Treas. Reg. §1.860I-2(b).
4. IRC Sec. 860I(d)(2).
5. Prop. Treas. Reg. §1.860I-1(c).
6. IRC Sec. 860I(b).
7. IRC Sec. 860I(c). See Prop. Treas. Reg. §1.860I-1(d).
8. IRC Sec. 860I(e).
9. IRC Sec. 860I(e).
10. IRC Sec. 860L(g).
11. IRC Secs. 860L(g), 52(a), 52(b).

For purposes of the wash sale rules (see Q 7535), an ownership interest is subject to rules similar to those applicable to REMICS (see Q 7674). Under those rules, an ownership interest is treated as a security, and an ownership interest and any interest in a taxable mortgage pool comparable to a residual interest in an ownership interest are treated as substantially identical stock or securities. Furthermore, the 30-day period in the wash sale rules is enlarged to six months in applying it to such interests.[1]

The FASIT anti-abuse rule evaluates transactions against the underlying purpose of the FASIT provisions, which is to promote the spreading of credit risk on debt instruments by facilitating the securitization of debt instruments. If a FASIT was formed or is used to achieve a tax result that is inconsistent with this purpose, the Commissioner may take remedial action including disregarding the FASIT election, reallocating items of income, deductions and credits, re-characterizing regular interests, and re-designating the holder of the ownership interest.[2]

7682. Must bonds be in registered form? What are "registration required" bonds?

Any obligation of a type offered to the public that has a maturity of more than one year must be in registered form (a "registration required" bond). This includes obligations of federal, state, and local governments as well as corporations and partnerships. An exception is made for certain obligations reasonably designed to be sold only outside the United States to non-United States persons and payable outside the United States and its possessions. However, if they are in bearer form, these obligations must carry a statement that any United States person holding the obligation will be subject to tax limitations.[3] A "United States person" is a United States citizen or resident, a domestic partnership or corporation, or an estate or certain trusts (other than a foreign estate or trust).[4]

Bonds that are "not of a type offered to the public" do not have to meet the registration requirement.[5] Temporary regulations state that a bond is "of a type offered to the public" if similar obligations are publicly offered or traded.[6] Even if a bond is not publicly traded, it may be considered "of a type offered to the public" if: (a) the bond would be treated as readily tradable in an established securities market under the installment sales rules; (2) the bond is comparable to a bond described in (1); or (3) similar obligations are publicly offered or traded.[7]

The Treasury also has authority to require registration of other obligations if they are used frequently for tax avoidance.[8]

1. IRC Secs. 860L(f)(1), 860F(d)(1).
2. See Prop. Treas. Reg. §1.860L-2.
3. IRC Secs. 103(b), 149, 163(f).
4. IRC Sec. 7701(a)(30).
5. IRC Sec. 163(f)(2)(A)(ii).
6. Temp. Treas. Reg. §5f.163-1(b)(2).
7. Prop. Treas. Reg. §5f.163-1(b)(2) (effective for bonds issued after January 21, 1993 unless substantially all of the terms of the obligation were agreed upon in writing on or before that date).
8. IRC Sec. 163(f)(2)(C).

A book entry obligation is considered registered if the right to principal of, and stated interest on, the obligation may be transferred only through a book entry system that identifies the owner of an interest in the obligation. Regulations may permit book entries in the case of a nominee or a chain of nominees.[1]

Registration is required for some U.S. Treasury issues after September 3, 1982, and other Treasury issues and issues of U.S. agencies and instrumentalities issued after 1982.[2] Obligations issued by other than the United States and its agencies and instrumentalities must be in registered form in order for the issuer (or holder, in some cases) to qualify for certain tax benefits (see Q 7683). This requirement generally applies to municipal bonds issued after June 30, 1983 (although some previously had to be in registered form in order to qualify for tax-exemption). Other bonds must be in registered form after 1982.

The constitutionality of the registration requirement was unsuccessfully challenged in *South Carolina v. Baker*,[3] in which the Supreme Court upheld the constitutionality of both the registration requirement and the tax consequences imposed on most unregistered bonds.

Issuers of registration required obligations not in registered form are denied a deduction for interest paid or accrued on the obligation, and their earnings and profits may not be decreased by such nondeductible interest (except for certain foreign issuers).[4] In addition, they are subject to an excise tax of 1 percent of the principal times the number of years to maturity, except in the case of obligations that would be tax-exempt if issued in registered form.[5]

Generally, then, the tax limitations apply to the issuer rather than the holder. However, in the case of obligations the issuance of which would not be subject to the 1 percent excise tax, and obligations that would be tax-exempt if issued in registered form, limitations are imposed directly on the holder (see Q 7683).

An obligation, the terms of which are fixed and for which full consideration is received before December 31, 1982, is not required to be registered even if smaller denomination certificates in that obligation are not distributed to ultimate investors until after that date, according to the General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982 by the Joint Committee on Taxation.

The Service has provided clarification on whether bonds held through certain book-entry systems are treated as registered or in bearer form under Treasury Regulation Sections 5f.103-1(c) and 1.871-14.[6]

1. IRC Secs. 149(a)(3), 163(f)(3), 4701(b), 165(j); Temp. Treas. Reg. §5f.103-1.
2. TEFRA Sec. 310(d).
3. 485 U.S. 505 (1988).
4. IRC Secs. 163(f); 312(m).
5. IRC Sec. 4701.
6. See Notice 2006-99, 2006-2 CB 907.

7683. What tax limitations apply to the holder of registration required bonds that are not in registered form?

Income from otherwise tax-exempt bonds that do not meet the registration requirement (see Q 7682) is not exempt from federal income tax in the hands of a U.S. person. However, this limitation does not apply to interest exempt from tax by the United States under a treaty.[1]

Loss on the sale, exchange, theft, loss, etc., of a registration required obligation that would be tax-exempt if registered is not deductible if the obligation is not in registered form.[2] Gain on sale or exchange of a registration required bond that would otherwise be tax-exempt but that is not registered must be treated as ordinary income. It is denied capital gain treatment.[3] These sanctions also apply to U.S. persons holding unregistered bonds that are not required to be registered because they were designed for distribution outside the United States.[4]

Regulations allow the loss deduction and capital gains treatment by a holder who, within 30 days of the date when the seller or other transferor is reasonably able to make the bearer obligation available to the holder, surrenders the obligation to a transfer agent or to the issuer for conversion into registered form.[5]

7684. What is a structured product? How are structured products taxed?

"Structured products are not specifically defined in the securities laws. They have been described as securities that may be derived from or based on a particular security or commodity, a basket of securities, an index, a debt issuance, or a foreign currency. Many involve innovative financing techniques creating customized financing and investment products to suit specific financial needs of customers. They may involve complex "tranched" (i.e., segmented) liabilities and transfers through special purpose vehicles. Such transactions may be structured for any number of reasons – for example, for principal protection, tax minimization, accounting cosmetics, monetization, or other specific purposes."[6] Some of the more popular types of structured products sold to retail investors include principal-protected notes, equity-linked notes, and indexed-linked notes.

The taxation of a structured product will depend on the tax treatment of its individual components. See Q 7517 – stock; Q 7550 through Q 7579 – options; Q 7621 through Q 7625 – corporate bonds; Q 7628 through Q 7634 – market discount; and Q 7635 through Q 7639 – original issue discount.

1. IRC Secs. 103(b), 149; Temp. Treas. Reg. §5f.103-1.
2. IRC Sec. 165(j)(1).
3. IRC Sec. 1287.
4. IRC Secs. 165(j), 1287(a).
5. IRC Sec. 165(j)(3); Treas. Reg. §1.165-12(c)(4).
6. "Speech by SEC Staff: Structured Finance Activities: The Regulatory Viewpoint," given by Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission to the International Bar Association Conference – Financial Services Section, Chicago, Illinois, September 20, 2006, at: www.sec.gov/news/speech/2006/spch092006mag.htm.