Treasury and Corporate Notes and Bonds

# Introduction

Treasury Notes and Bonds

Treasury bonds and notes are obligations of the federal government. They are essentially similar, except that bonds mature in more than ten years while Treasury notes have maturity dates ranging from one to ten years. (On November 2, 2005, the United States Treasury announced the reintroduction of regular semi-annual auctions of the 30-year bond beginning with a bond that will mature on February 15, 2036.)

Treasury notes pay a fixed rate of interest every six months until maturity, at which time face value amount is paid.  Treasury sells two kinds of notes, fixed-principal and inflation-indexed. Both pay interest twice a year, but the principal value of inflation-indexed securities is adjusted to reflect inflation as measured by the Consumer Price Index--the Bureau of Labor Statistics' Consumer Price Index for All Urban Consumers (CPI-U). Thus, the adjusted principal amount is effectively determined as of the date of each interest payment, based upon the change in the CPI-U from the date of issuance of the obligation to the date of the interest payment.

In the event that the CPI-adjusted principal amount as of the maturity date is less than the original principal amount at issuance, the original principal amount will nonetheless be paid , this feature is referred to as a "minimum guarantee payment."  TIPS are issued in denominations of $1,000 and multiples of $1,000.

Treasury bonds and notes are issued in denominations ranging from $1,000 to $5,000,000. Bonds issued after September 3, 1982 and notes issued after 1982 must be in registered form; 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 a Federal Reserve bank or branch. In the case of registered obligations, interest payments are mailed 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.

Corporate Notes and Bonds

Corporate bonds of the same issue are similar or identical in their terms, although maturity dates of a serial issue will vary. Different issues may vary substantially in terms. Maturities can range from short-term to long-term. Bonds may be secured or unsecured, and their quality can range from excellent to very risky. Individual bonds

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usually have a minimum denomination of $1,000. Interest is usually payable semi-annually, although monthly, quarterly, and annual payments are sometimes found. Generally, bonds issued after 1982 must be in registered form. Interest payments on registered bonds are made by check sent to the owner; interest on bearer bonds is paid upon presentation of coupons cut from the bond. Some corporate debt securities are referred to as corporate “notes”. The difference between a corporate “bond” and a corporate “note” is more a matter of terminology than anything else. A debt security that is issued with a maturity date of more than seven to ten years generally is referred to as a bond. If the debt has an original maturity date of less than seven to ten years into the future, it is frequently called a note.

Inverse Relationship between Interest Rates and Bond Prices

Once a bond is issued its price moves up or down, that is, inversely to changes in the general level of interest rates. When interest rates rise, the price of a bond goes down because its coupon rate (the promised "contractual" rate of interest) is now lower than the higher rates of interest enjoyed by newly issued bonds of comparable credit risk. If general market interest rates fall, the bond's coupon rate becomes more attractive to investors, which increases the price. These price fluctuations are referred to as "market risk". For example, if a $1,000 bond maturing in 20 years has a coupon rate of 6 percent (i.e., pays interest at the fixed amount of $60 per year), but the prevailing market interest rate for long-term bonds of comparable quality is 8 percent, the 6 percent bond would be valued in the marketplace at only $750. This is the purchase price at which a buyer would be achieving an effective 8 percent rate of return, since the annual interest payment on the bond is fixed at $60 ($60/$750=8%).

The longer the maturity of the bond, the more its market price tends to be affected by fluctuation in prevailing market interest rates. While the closer the maturity date, the closer the market value will be to the bond's par value. This is because if the bond is held to maturity, the investor will receive the actual face amount of the bond.

How Bonds Are Traded

Bonds are normally issued in par or face value denominations of $1,000. They are quoted in the public trading market by reference to a percentage of their par value. For example, a bond that is selling for $1,000 would be quoted at 100 (i.e., 100 percent of par value). If a bond is quoted at 104, this would mean a price of $1,040 for each $1,000 bond (104 percent of the par value). Unlike stocks, bond market transactions do

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not usually involve commissions to the brokers involved. Bonds are traded by bond dealers with a spread between the amounts bid for purchases by the dealer and the amounts asked for sales by the dealer. For example, a bond may be quoted at 104 bid / 106 asked. The retail brokerage through which an investor buys or sells a bond will receive a portion of the bond dealer's spread as its compensation in lieu of a commission from the investor.

Call Features

Bonds often contain a provision allowing the issuer to repay the bond before its scheduled maturity. This is known as a "call" provision, apparently referring to the issuer calling the bonds in for repayment. Call features are generally disadvantageous to investors, since the investor cannot be assured that the expected periodic income from the bond will continue to the scheduled maturity date. The most likely reason for an issuer to call a bond is when interest rates have declined sufficiently enough were it can refinance the bond through a new bond issue (or other form of new financing) at a lower interest rate. This means that the investor whose bond is paid off through a call will likely be faced with lower prevailing market interest rates for reinvestment of the funds received.

Call features are often deferred, not becoming applicable until the bond has been outstanding for a stated period, so that investors can be assured of their expected return for at least a minimum number of years. For example, the call feature may not apply until the bond has been outstanding for at least five (or ten, etc.) years. To compensate investors for this uncertainty, an issuer will pay a slightly higher interest rate than would be necessary for a similar, but non-callable bond. Additionally, issuers may offer bonds that are callable at a price in excess of the original par value. For example, the bond may be issued at a par value of $1,000, but be called away at a par value of $1,050. The issuer's cost takes the form of overall higher interest costs, and the investor's benefit is overall higher interest received.

Bond Ratings

Bonds, whether issued by corporations or by governmental bodies, all involve a degree of risk that the issuer, because of unanticipated financial difficulties, will be unable to pay a future interest payment or repay the principal amount upon maturity (referred to as a "default"). Because different issuers have widely varying degrees of financial strength, the chances of a future default will vary accordingly. These differences in financial strength are important to investors choosing among alternative bond vehicles.

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Evaluating issuers' financial strength involves sophisticated economic, business and accounting analysis, which is performed by independent agencies that publish the results in the form of rating categories. The two primary firms providing these ratings are Standard & Poors and Moody's. Ratings are periodically updated, taking into account issuers' changing financial circumstances. Investors rely on these ratings as a measure of the relative safety of any particular bond issue.

Bond ratings have an important bearing on the interest rate and effective yield on bonds. In general, the higher the bond rating, the more valuable the bond (all other factors being equal), and the lower the effective yield. For example, if two municipalities were each issuing bonds with identical terms, the issuer with the lower bond rating would probably have to offer a higher interest rate. A high level of outstanding debt is a major factor in reducing the rating on any new debt issue. Thus, for example, states and cities with unusually high outstanding debt can anticipate a higher borrowing cost for additional bond issues.

Investment Grade Bonds

The term "investment grade" is used to describe bonds in the highest rating categories (Moody’s long-term-Baa3 / short-term-P-3 and S & P’s long-term-BBB / short-term-A-3). These involve the lowest risk of loss of principal or interest. Many fiduciaries and institutional investors, such as insurance companies, pension funds and banks, will confine their bond investments to investment grade bonds.

High-Yield ("Junk") Bonds

Bonds in the lowest rating categories (Moody’s long-term-Ba1 / short-term “not prime” and S & P’s long-term-BB+ / short-term-B) are considered to bear a degree of default risk that is unacceptable to conservative investors, concerned with preservation of capital. Because of the low ratings and higher risk, these bonds typically offer investors a higher effective yield; thus, they are often referred to as high-yield bonds, and if the default risk is great enough that an investment in such a bond issue would have to be viewed as speculative, it would be referred to as "junk bond.".

Taxation Generally

Basically, the taxation of bonds is not complicated if the bond was not issued with original issue discount, if it was not bought with market discount, and there is no borrowing attributed to buying or holding it. A bond in the hands of an investor is a capital asset. Stated interest is taxed when it is received by a cash basis taxpayer, and

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gain or loss on sale is capital gain or loss. The tax rules get more complicated if the bond was originally issued at a discount. Depending on when the bond was issued, the discount must either be included in income as it accrues, even by a cash basis investor, or part of the gain on sale must be treated as discount (interest) received. There are specific rules for determining the amount of discount which is includable in income. These rules are summarized in If Bond has Original Issue Discount and Gain.

If the bond was purchased on the market at a discount, gain on sale or retirement of the bond attributable to market discount is treated as interest or as capital gain, depending on when the bond was issued or acquired. There are elections which permit current inclusion of market discount as it accrues and different methods for determining the amount of accruing market discount.

Deduction of interest on borrowing to buy or carry market discount bonds is subject to special rules and can affect the taxation of market discount.

Finally, acquiring, holding, selling, or making elections with respect to other property may have an effect on the tax treatment of a particular bond.

# Tax While Bond or Note Held

Interest Payments Received

Unless the note or bond was issued before March 1, 1941 (in which case it may be only partly taxable), stated interest which 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.) 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).

If an individual purchased the bond between interest dates and paid the seller interest accrued but not yet due at the date of purchase, he does not deduct the amount or include it in his basis; he recovers the amount tax free out of his first interest payment and includes in income only the balance. *L.A. Thompson Scenic Railway Co. v. Comm.,* 9 BTA 1203 (1928); Rev. Rul. 69-263, 1969-1 CB 197.

Interest on Treasury notes and bonds issued before March 1, 1941 may be only partly taxable. Treas. Reg. §1.61-7.

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Bonds Traded “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 he receives attributable to interest which accrued *before* he purchased the bond as a return of capital which reduces his basis. Amounts received in excess of capital (i.e., the tax basis in the bond) are capital gain. *Rickaby v. Comm.,* 27 TC 886 (1957); Rev. Rul. 60-284, 1960-2 CB 464. They are not treated as interest. *First Kentucky Co. v. Gray,* 190 F. Supp. 824 (W.D. Ky. 1960).

The owner of a bond, whether or not purchased flat, treats any payment attributable to defaulted interest which accrued *after* he purchased 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. *Fisher v. Comm.,* 209 F.2d 513 (6th Cir. 1954), *cert. den.* 374 U.S. 1014; *Jaglom v. Comm.,* 36 TC 126 (1961), *aff’d* 303 F.2d 847 (2d Cir. 1961); *Allen Tobey v. Comm.,* 26 TC 610 (1956); *Shattuck v. Comm.,* 25 TC 416 (1955); *First Kentucky Co. v. Gray,* above; Rev. Rul. 60-284, above.

If Bond Has Original Issue Discount

When an obligation is originally issued at a price which is less than its stated redemption price at maturity, the difference is “original issue discount” (OID). IRC Sec. 1273(a). This discount serves the same economic function as interest. The tax laws have long recognized this and tax it as such. Thus, anyone holding a bond originally issued at a discount must account for the part of the discount attributable to the period he holds the bond as interest under a special set of tax rules. However, if the discount at issue is “de minimis” (that is, it is less than ¼of one percent of the stated redemption price multiplied by the number of complete years from the date of original issue to maturity), the bond is treated as if there were no original issue discount. IRC Sec. 1273(a)(3). Furthermore, an individual who purchases a bond after issue at a premium (i.e., at an amount in excess of the face value of the bond) may treat the bond as if it had not been issued with original issue discount. IRC Sec. 1272(c).

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The rules for taxing original issue discount have changed over the years, and thus they differ depending on when a bond was issued. Normally, Treasury notes and bonds are issued at a discount of less than ¼ of one percent multiplied by the number of years to maturity. Consequently, the original issue discount rules do not ordinarily apply to them. Other taxable bonds issued by governmental bodies and political subdivisions may be issued at a greater discount and come within the original issue discount rules.

#### Issued After July 1, 1982

If a 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”. (A discount of less than ¼ of one percent times the number of years from issue to maturity may be disregarded. This is normally the case with Treasury notes and bonds.) IRC Sec. 1273(a). The holder’s basis is increased by the amount of original issue discount he actually includes in income each year. IRC Sec. 1272(d).

#### Issued Before July 2, 1982

If a government obligation was originally issued before July 2, 1982, the amount of original issue discount is not includable in income until it is received on sale or maturity of the obligation. IRC Secs. 1271(b), 1271(c)(2); Treas. Reg. §1.61-7(c).

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Unless the bondholder purchased the bond at a premium or the amount of original issue discount is “de minimis,” the holder of a bond originally issued at a discount after May 27, 1969 must include in his income each year a portion of the original issue discount. IRC Secs. 1272(a), 1272(b); see Treas. Reg. §1.1232-3.

Original issue discount on bonds issued before May 28, 1969 is not included in income prior to sale or maturity. IRC Sec. §1271(c).

Effect of Original Issue Discount on Basis

The basis of the note or bond is increased by the amount of original issue discount included in income as it accrues each year. IRC Sec. 1272(d)(2).

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If Bond Has Market Discount

Bond prices are discounted on the market to bring bond yields in line with higher market interest rates. Thus, market discount functions as an increase in the interest paid on the bond. However, the tax laws did not treat market discount as interest until the 1984 Tax Reform Act. Even so, unlike original issue discount, market discount is not includable in income by a cash basis investor before sale or disposition of the bond or note. IRC Sec. 1276(a). However, an election may be made to include market discount as it accrues on bonds and notes. Certain obligations are excepted from this election (see below). IRC Sec. 1278(b).

Market Discount Defined

Market discount is the amount by which (1) the stated redemption price of a bond issued at par exceeds (2) the taxpayer’s basis in a bond immediately after its acquisition. IRC Sec. 1278(a)(2). For tax purposes, the term “market discount bond” does not include tax free municipal obligations purchased before May 1, 1993, short-term obligations, United States Savings Bonds, or certain obligations arising from installment sales of property. IRC Sec. 1278(a)(1).

If the bond was originally issued at a discount, market discount is the amount by which (1) the original issue price increased by the amount of original issue discount accruing since issue up to the date of acquisition exceeds (2) the basis immediately after acquisition. IRC Sec. 1278(a)(2)(B).

If market discount is “de minimis” (i.e., less than 1/4 of one percent of the redemption price multiplied by the number of complete years to maturity), the bond is treated as if there were no market discount. IRC Sec. 1278(a)(2)(C).

Election to Tax Market Discount Annually

An election may be made to include market discount in income each year as it accrues on a taxable bond or note instead of waiting until the bond or note is sold or redeemed. IRC Sec. 1278(b).

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 one percent 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 has made an election to

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include accrued market discount with respect to that bond or other market discount obligations. See IRC Sec. 1278(b). This election is generally not advantageous unless it is necessary to permit the 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.

Effect of Election on Other Obligations

Once the election is made, it applies to *all*  obligations having market discount (other than tax free obligations purchased before May 1, 1993, short-term obligations, certain obligations arising from installment sales of property, or 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). This election continues in effect until the IRS agrees to the revocation of the election. IRC Sec. 1278(b).

Market discount includable under the election is 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. 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 which has accrued up to that time. The amount of accrued market discount is reduced accordingly. IRC Sec. 1276(a)(3). If the principal of a bond acquired after October 22, 1986 is to be paid in two or more payments, the amount of accrued market discount is to be determined under regulations. IRC Sec. 1276(b)(3).

Deductions

Deduction of Bond Premium

When a bond is selling on the market at a premium (i.e., at a price in excess of its face value), it is generally because the bond carries a higher coupon interest rate than the market interest rate for bonds of similar quality. The premium serves to bring the yield in line with the lower market rate.

Recognizing that premium is an interest adjustment, the Code permits a bond owner to elect to amortize the premium over the life of the bond (or in some cases, until an earlier call date), thereby offsetting a part of the yearly interest income on the bond with a deduction each year. IRC Sec. 171(a).

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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 consent of the Service. IRC Sec. 171(c)(2). 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. IRC Sec. 171(d). The bond owner is not required to amortize premium on taxable bonds just because he has *tax-exempt* bonds which he is amortizing. IRC Sec. 171(c)(1).

If the bond owner elects to amortize, he must also reduce his basis in the bond by the amount of premium which is an allowable deduction or which was applied in reduction of interest payments each year. IRC Sec. 1016(a)(5); Treas. Reg. §1.1016-5(b). If in any year an individual, who amortizes bond premium by deducting it as an interest expense, does not itemize his deductions but takes a standard deduction, the deduction is deemed to have been allowed and reduces his basis. Treas. Reg. §1.1016-5(b). An individual may, but need not, amortize premium in a year in which no interest is received. Treas. Reg. §1.171-2(e).

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 it cost, or is deducted as a capital loss if the bond is redeemed at face value or sold for less than the basis.

Deduction of Interest Expense on Amounts Borrowed to Buy Bond

If interest is paid on borrowing incurred or continued by the taxpayer in order to purchase or carry bonds acquired at market discount, deduction of the interest expense may be subject to limitation and deferral. IRC Secs. 1277(a), 1278(a)(1)(C). Even if borrowing is not for the express purpose of buying a market discount bond, borrowing may be inferred to be for this purpose if one borrows to purchase another investment while holding market discount bonds or if one buys market discount bonds while other investment indebtedness is outstanding.

Any amount deductible under these rules will also be subject to the general limit on otherwise allowable deduction of investment interest even if the deduction is not deferred.. Certain short sale expenses may be treated as interest within this rule. IRC Sec. 1282(c). See General Explanation – TRA ’84, p. 98.

Loss on Worthless Bonds

A deduction may be taken for a long-term or short-term capital loss in the year a bond becomes worthless. IRC Sec. 165(g).

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# Tax at Retirement, Redemption, or Sale

On sale or on redemption at maturity, the proceeds can be composed of amounts which receive different tax treatment. Therefore, it may be necessary to separate the proceeds into identifiable components for tax purposes. These separate parts can be one or more of the following: cost (investment), payment of stated interest, original issue discount, market discount, and capital gain.

Amounts received on retirement of an obligation are treated as amounts received on sale (but for an obligation issued before 1955, only if the obligation was in coupon or registered form on March 1, 1954). IRC Secs. 1271(a), 1271(c); Treas. Reg. §1.1232-1(a).

Stated Interest

Sale Between Interest Payment Dates

If the sale occurs between interest due dates, as it generally does, the seller 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 amount is includable in income by the seller as interest, even if the sale price is less than the seller’s basis and he does not fully recover his investment. Treas. Reg. §1.61-7(d).

Interest Paid at Maturity

The interest payment due and paid on maturity is includable in income when received. This is reported by the bond owner as interest income, not as a return of capital or gain. Treas. Reg. §1.61-7.

Bond Traded “Flat”

If the bond was purchased at a time when principal or interest was in default and later the face amount and all interest accrued before and after purchase is paid in full on redemption of the bond by the obligor, only the amount of interest accrued after purchase is interest. *Allen Tobey v. Comm.,* 26 TC 610 (1956).

Cost Recovery

Out of the proceeds (other than interest discussed above), an amount equal to the investor’s adjusted basis in the note or bond and expenses of sale are recovered tax-free. IRC Sec. 1001(a). His basis is generally his cost of acquisition plus brokerage fees

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and commissions adjusted by (1) adding any original issue discount included in income as it accrued and market discount included in income prior to sale (IRC Secs. 1272(d), 1276(d)(2), 1278(b)(4); General Explanation – TRA ’84, p. 99), or (2) subtracting the amount of premium deductible or applied to reduce payments if an election was made to amortize bond premium. (IRC Sec. 1016(a)(5)).

In the case of a bond received by a gift, the donee’s basis for determining gain is generally the same as the basis the donor had at the time of the gift (plus gift tax attributable to any appreciation in value), adjusted for discount (market and original issue discount) included in income by the donee or by premium deductible (if the amortization election is in effect). IRC Secs. 1015(a), 1016(a)(5). His basis for determining loss is the fair market value of the property at the time of the gift if it was lower than the donor’s basis, adjusted for discount included in income by the donee or for bond premium deductible by the donee. IRC Sec. 1015(a), 1016(a)(5); Treas. Reg. §1.1016-5(b).

The basis of an individual who inherited a bond is the fair market value at the date of death or other value reported on the estate tax return, adjusted for discount included in income after inheriting it or premium deducted. IRC Sec. 1014.

Gain

As a general rule, amounts in excess of stated interest (Stated Interest above) and basis (Cost Recovery) are treated as capital gain – long-term or short-term depending on the holding period and the date of acquisition. 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 be treated as interest instead of capital gain, if the discount was not included in income as it accrued. (Discount which is less than 1/4 of one percent of face value multiplied by the number of complete years to maturity is considered no discount.) 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, and obviously there is no market discount. IRC Sec. 1271(a)(2)(B).

The installment method for reporting gain is not available for securities traded on an established securities market. As a result, gain from the 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. IRC. Sec. 453(k). See Rev. Rul. 93-84, 1993-2 CB 225. However, for sales that occurred before 1987, gain could be reported on the installment method. In the event of such a pre-1987 sale between *related parties*, there is a “second disposition” rule, which provides generally that the seller’s gain will be

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accelerated if there is a second disposition of the stock by the related purchaser before all payments have been made. IRC Sec. 453(e).

Market Discount

If a 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. IRC Sec. 1276(a)(4). 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 of all of the gain must be treated as ordinary income to the extent that a deferred interest expense deduction is taken.

If the taxpayer had previously elected to include market discount in his income annually as it accrued, his gain would not include previously included market discount. IRC Sec. 1278(b). This rule reflects recognition that market discount is a substitute for stated interest.

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.

Original Issue Discount

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If a Treasury note or bond originally issued on or before July 1, 1982 and after December 31, 1954 was originally issued at a discount of 1/4 of one percent 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. IRC Sec. 1271(c)(2).

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. IRC Sec. 1271(a)(2)(B). The holder is considered to have purchased at a premium if his 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, the donee is considered to have purchased at a premium if the donor did. Treas. Reg. §1.1232-3(d)(2).

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With respect to bonds issued before January 1, 1955, the Code did not deal with the problem of original issue discount; nonetheless, the Supreme Court 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. *U.S. v. Midland-Ross Corp.*, 381 U.S. 54 (1965). However, gain or loss from *retirement* of a bond is a 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. IRC Sec. 1271(c).

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If the bond was originally issued at a discount of 1/4 of one percent or more of the face amount multiplied by the number of complete years from issue to maturity and the seller had not purchased the bond at a premium, a part of any *gain* 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, and the basis is adjusted for amounts included (IRC Sec. 1272(d)(2)). 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. IRC Sec. 1271(a)(2).

*If the bond was issued on or before May 27, 1969 and after December 31, 1954*, any gain realized on a sale or redemption is taxed as ordinary income to the extent of an amount which 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 another person. See Treas. Reg. §1.1232-3(c). However, if there was no 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. IRC Sec. 1271(c)(2)(A)(ii).

*If the obligation was issued before January 1, 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. *U.S. v. Midland-Ross Corp.*, 381 U.S. 54 (1965).

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Loss

Loss on sale or redemption is treated as a capital loss – long-term or short-term depending on the length of the holding period. No original issue discount or market discount is recovered. However, if “substantially identical” obligations were acquired (or a contract for their acquisition was made) within 30 days before or 30 days after the sale, the loss will be subject to the “wash sale” rule. If the sale is made to a related party, the loss deduction may be disallowed.

Transfer To Spouse

Generally, neither gain nor loss is recognized on a transfer of bonds after July 18, 1984 between spouses, or between former spouses if incident to divorce. See IRS Pub. 504 (1993). The property will be treated as if the transferee acquired it by gift, and the transferor’s basis will be carried over to the transferee regardless of the fair market value of the property. IRC Sec. 1041.

Deduction of Deferred Interest Expense

Any deferred interest expense not previously deducted, because it was paid on borrowing to buy or hold a market discount bond, is generally deductible in the year the bond is sold or redeemed. IRC Sec. 1277(b)(2).

Holding Period for Determining if Gain or Loss is Long-Term or Short-Term

Generally, the holding period begins the day after the bond is purchased and includes the day the bond is sold. 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 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. Rev. Rul. 78-5, 1978-1 CB 263.

The donee of a bond includes in his holding period the time the bond was held by the donor. IRC Sec. 1223(2).

Gift Between Interest Payment Dates

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

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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. Rev. Rul. 72-312, 1972-1 CB 22.

Gift of Bond with Market Discount

When a taxpayer makes a gift of a taxable bond issued after July 18, 1984, or 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 he acquired at a market discount and which has appreciated in value at the time of the gift, he must include in his gross income an amount equal to the market discount accrued to the date of the gift, but limited to the amount of gain he would have realized had he received fair market value on making the gift. IRC Sec. 1276(a)(2). The amount is treated as interest income (but not for withholding at the source). General Explanation – TRA ’84, p. 94. 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 had sold the bond. Had he previously elected to include market discount in his gross income as it accrued, no accrued discount would be includable as a result of the gift. IRC Sec. 1278(b).

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. TRA ’84, Sec. 44(c)(1). See IRC Secs. 1276, 1277, and 1278.

# Bond Swap

Investors sometimes find it advantageous to engage in a “bond swap.” Bonds swaps are generally made to improve a portfolio by upgrading the quality of bond holdings or to use a tax loss on a bond to offset capital gain, at the same time retaining the character of a portfolio by replacing the bond sold with another. If losses exceed gains or an investor has no capital gain during the current year, the investor may deduct up to $3000 of the losses from ordinary income and carry forward the excess losses to future tax years. IRC Secs. 1211(b), 1212(b).

A swap is in reality a sale of one bond and a purchase of another. Gain or loss is recognized at the time the bond is sold.

If an acquisition of or a contract to acquire “substantially identical” bonds is made 30 days before or 30 days after the bond is sold, loss on the sale may not be recognized under the wash sale rule.

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# Effect on and of Other Transactions

Under the tax laws, transactions do not stand by themselves. The taxation of bonds can be affected by other activities of the bond investor, and other transactions can be affected by the purchase of a bond.

1. If a bond was held as part of a tax straddle, the additional rules and qualifications concerning straddles apply. See IRC. Sec. 1092.

2. If “substantially identical” securities are bought within 30 days before or 30 days after the sale of a bond, the wash sale rule may prevent taking a loss deduction on the sale.

3. If an election has been made with respect to other obligations having maturities of more than one year to include market discount as it accrues, the election applies to any obligation acquired in the first year to which the election applies or later. See If Bond has Market Discount, above.

4. Borrowing done for investment purposes which is still outstanding when market discount bonds are purchased or new debt undertaken at a time when market discount bonds are held can result in deferral of the deduction of interest expense on the borrowing, as explained in Deductions, above.