Bond Premium: Taxable Bonds

# General

When a bond is purchased at a price greater than the bond's principal or face amount, whether upon original issuance or in the market thereafter, the excess is referred to as bond "premium." This premium is included in the investor's tax basis, and thus will affect the amount of capital gain or loss upon resale of the bond. If the bond is held to maturity (and the bond premium has not been subject to annual amortization, as discussed below), the investor will receive less than his or her original cost; and the difference will be a capital loss.

# Election to Amortize Premium

Recognizing that premium is an interest adjustment, the Code permits a bond owner who purchased a taxable bond at a premium, whether or not on original issue, to elect to amortize the premium over the life of the bond (or in some cases, until an earlier call date). IRC Sec. 171(a).

The election to amortize premium with respect to taxable bonds is made by including the amount of the year's amortization as a reduction of interest income for the tax year, and including a statement showing this calculation [Treas. Regs. §§ 1.171-3(a) and 1.171-3(c)]. Once the election is made, it must be applied with respect to all bonds acquired at a premium, including any subsequently acquired. The election may not be revoked, except with specific IRS consent [IRC Sec. 171(c)(2)]. The amount of annual amortization reduces the bondholder's tax basis in the bond [IRC Sec. 1016(a)(2)].

If the election to amortize 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. If the bond is redeemed at face value or sold for less than the basis, and the owner did not elect to amortize, the premium may be deducted as a capital loss.

Method of Amortizing Bond Premium

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. IRC Sec. 171(e).

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.

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TAMRA ’88, Sec. 1803(a)(11)(B). These taxpayers treat the deduction as investment interest expense subject to the investment interest deduction limitations. IRC Sec. 171(e), as in effect prior to amendment by TAMRA ’88, §1006(j)(1).

With respect to bonds acquired before October 23, 1986, a taxpayer who elected to amortize takes an annual itemized interest expense deduction. IRC Sec. 171(a). The deduction is not subject to the 2% floor on miscellaneous deductions. IRC Sec. 67(b)(11); see Conf. Report 99-841, Vol. II at page 34, 1986-3 CB Vol. 4. 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. P.L. 400-647, §1006(j)(2) (TAMRA ’86).

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. Treas. Reg. §1.171-3(a). The election to amortize could not be made in a refund claim. *Bessie A. Woodward Est. v. Comm.*, 24 TC 883 (1955) *aff’d sub. nom. Barnhill v. Comm.*, 241 F.2d 496 (5th Cir. 1957). It would seem likely that the IRS will permit an individual who amortizes by offsetting interest payments to indicate similarly his election on his return by making the reduction for the first year to which he wishes the election to apply.

Amount Amortizable

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 amount payable at the earlier call date if using the earlier call date would result in a smaller amortizable amount being allocated to the year. IRC Sec. 171(b)(1); Treas. Reg. §1.171-2(a)(2). 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).

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. IRC Sec. 171(b)(4). This rule applies to exchanges occurring after May 6, 1986. TRA ’86, Sec. 1803(a)(12)(A). A special rule applies to a bond acquired in a bond-for-bond exchange in a corporate reorganization. IRC Sec. 171(b)(4)(B).

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Calculation of Annual Deduction or Offset

Except as provided in regulations, 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. If the amount payable on a call date which 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. IRC Sec. 171(b)(3). 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). TRA ’86, Sec. 1803(a)(11)(A).

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, he must consistently use the same method. (The Service has approved use of the “yield” method of amortizing bond premium. Rev. Rul. 82-10, 1982-1 CB 46.) Instead of any other method, he may use the straight line method set forth in the regulations. Under that method, the amount of premium that is deductible or offset each year is an amount which 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. Treas. Reg. §1.171-2(f).

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, he must treat them as part of the premium if he uses the straight line method. Treas. Reg. §1.171-2(d).

Earlier Call Date

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

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date, prior to maturity, specified in the bond as may be selected by the taxpayer. Treas. Reg. §1.171-2(b). Where amortization is determined with respect to one of 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.

If the bond is called, the amount of premium that may be offset or deducted 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. IRC Sec. 171(b)(2).

Basis Adjustment

In determining each year the amount of premium to be amortized, the basis is adjusted for amortizable premium previously deducted or offset. Treas. Reg. §1.171-2(f)(2)(ii). Also, an adjustment must be made for premium not amortized in years the individual held the bond before he elected to amortize. However, this adjustment is made only for the purpose of determining the amortizable amount; the amount not amortized before the election does not affect basis for determining gain or loss on sale or exchange. Treas. Reg. §1.171-2(a)(4).

*Example:* Mr. Sparks bought a taxable $100 20-year bond for $120. After holding the bond for 11 years, he elects to amortize the premium allocable to the remaining years. Solely for purposes of determining the amount amortizable over the remaining years, Mr. Sparks must treat the premium as having been amortized over the previous 11 years. He will treat $11 as already amortized and will deduct (or offset) the remaining $9 over the last 9 years. Because the $11 adjustment does not affect basis, Mr. Sparks will have an $11 capital loss in the year of redemption attributable to the period prior to making the election.

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.

*Example:* On January 1, Mrs. Hoag’s father gave her a taxable $100 20-year bond maturing 10 years later. Her father originally purchased the bond on January 1, ten years earlier, for $120; its value at the time of the gift was $127. Mrs. Hoag’s basis for determining loss is $120. If Mrs. Hoag elects to amortize the premium, she must treat the bond as amortized over the 10 years it was held by her father because her holding period as a donee is deemed to include that of the donor. Mrs. Hoag may amortize the $10 over the remaining 10 years. She will realize a $10 long-term capital loss if she holds the bond to maturity, reflecting her father’s holding period.

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Effect of Election to Amortize Premium

Applies To Other Bonds

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. 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 taxpayer is not required to amortize premium on taxable bonds just because he has *tax-exempt* bonds which he is amortizing.

Basis in Bonds Reduced

If the taxpayer 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. §1.171-1(e).

Premium in Year No Interest Received

An individual may, but need not, amortize premium in a year in which no interest is received. Treas. Reg. §1.171-2(e).

Amortization Disallowed

The Service will disallow amortization of premium in situations that lack economic substance. Rev. Rul. 62-127, 1962-2 CB 84. A deduction for amortization was disallowed where sales were not bona fide sales (*Lieb v. Comm.,* 40 TC 161 (1963)) and also where an individual, 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 (*Starr v. Comm.,* 46 TC 450 (1966)).