Bond Premium: Tax-Exempt Bonds

# General

A premium paid on the market for a tax-exempt bond, in effect, offsets the interest paid on the bond. Since the interest is tax-exempt, no deduction is permitted for amortization of the premium. Nonetheless, an individual who owns any fully tax-exempt interest bearing bond (or debenture, note, certificate, or other evidence of indebtedness) must amortize the premium by reducing his basis each year by the amount of premium allocable to the year. IRC Sec. 171; Treas. Reg. §1.171-1(c); IRC Sec. 1016(a)(5).

# Amount Amortizable

Bond premium which 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). IRC Sec. 171(b)(1). (A taxpayer’s basis for determining loss can be lower than his basis for determining gain, as in the case of a gift where the donor’s tax basis in the bond was greater than the fair market value of the bond at the time of the gift. In that case, the basis for determining loss is the fair market value at the time of the gift, and the basis for determining gain is the donor’s basis. IRC Sec. 1015(a).)

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.

Calculation of Amount Amortized

Bonds Issued After September 27, 1985

Except as provided in regulations, the determination of 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. 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).

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Bonds Issued on or Before September 27, 1985

The amount of premium allocable to 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, the taxpayer may use the straight line method set forth in the regulations. Under that method, the amount of premium which is allocable to 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 the 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 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).

Where there is more than one call date, the premium paid for a tax-exempt bond must be amortized to the earliest call date. Pacific Affiliate, Inc. v. Comm., 18 TC 1175 (1952), aff’d 224 F.2d 578, cert. den. 350 U.S. 967. 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. Rev. Rul. 60-17, 1960-1 CB 124. 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.

# Premium Paid on Call

Premium paid on call of a tax-exempt bond before maturity is a capital payment taxable as a capital gain. Rev. Rul. 74-172, 1974-1 CB 178; District Bond Co. v. Comm., 1 TC 837 (1943); Bryant v. Comm., 2 TC 789 (1943).