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.[[1]](#footnote-1)

(2) Proceeds in excess of item (1), above, are recovered tax-free to the extent of the investor’s adjusted basis in the bond.[[2]](#footnote-2) 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 and market discount included in income prior to the sale, or (b) subtracting amounts of premium deductible or applied to reduce interest payments if an election was made to amortize bond premium .

(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. 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 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. 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.

(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 and basis is adjusted for amounts included.[[3]](#footnote-3) 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.[[4]](#footnote-4)

*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.[[5]](#footnote-5) 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.[[6]](#footnote-6)

*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.[[7]](#footnote-7)

(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 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.

(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).[[8]](#footnote-8)

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.[[9]](#footnote-9)

Generally, neither gain nor loss is recognized on a transfer between spouses, or between former spouses if incident to divorce.[[10]](#footnote-10)

1. . Treas. Reg. §1.61-7(d). [↑](#footnote-ref-1)
2. . IRC Sec. 1001(a). [↑](#footnote-ref-2)
3. . IRC Sec. 1272(d)(2). [↑](#footnote-ref-3)
4. . IRC Sec. 1271(a)(2). [↑](#footnote-ref-4)
5. . See Treas. Reg. §1.1232-3(c). [↑](#footnote-ref-5)
6. . IRC Sec. 1271(c). [↑](#footnote-ref-6)
7. *. U.S. v. Midland-Ross Corp.*, 381 U.S. 54 (1965). [↑](#footnote-ref-7)
8. . IRC Secs. 1271(a), 1271(c). [↑](#footnote-ref-8)
9. . IRC Sec. 453(k). See Rev. Rul. 93-84, 1993-2 CB 225. [↑](#footnote-ref-9)
10. . IRC Sec. 1041. [↑](#footnote-ref-10)