Guide to Bond Premium and Market Discount

Authors:
Carol Warley, partner, RSM US LLP
Stefan Gottschalk, senior director, RSM US LLP
Corey Junk, manager, RSM US LLP

Market purchases of bonds, adjustments to taxable income and forms 1099

For taxpayers who purchase bonds or other debt instruments (Bonds), the Tax Code[1] may require adjustments to ordinary interest income. This guide addresses two types of adjustments – bond premium and market discount.

Where they apply, the bond premium and market discount rules affect the characterization of Bond holders' income as capital or ordinary, as well as the timing of certain ordinary interest income. Both the bond premium and market discount rules generally affect the amount of gain or loss and ordinary income recognized upon sale or disposition of a Bond. Bond premium adjustments to interest income may also apply while the taxpayer holds a Bond.

The bond premium and market discount rules both address situations where a Bond holder has purchased a debt instrument at a price that differs from a baseline amount. The applicable baseline amount is often, but not always, equal to the Bond's stated principal amount (often known as its 'face amount' or 'par value'). For bond premium, the baseline amount is the amount of all remaining payments other than qualified stated interest. For market discount, the baseline amount is the Bond's adjusted issue price.

Bond premium and market discount arise because of market price changes. For example, a Bond's value may decrease due to an increase in market interest rates or deterioration of the issuer's credit quality. Conversely, a Bond value may increase due to a decrease in market interest rates or improvement of the issuer's credit quality.

Bond holders generally receive Forms 1099 annually unless they are 'exempt recipients.' Exempt recipients generally include corporations, governments, tax-exempt entities and certain other taxpayers (S corporations, however, are not exempt recipients with respect to Forms 1099-B). Bond holders' Forms 1099-B (regarding sales proceeds and tax basis) and 1099-INT/OID (regarding interest income) often reflect bond premium and market discount-related information.

The level of completeness and accuracy of the Form 1099 information, however, may vary. For example, variations in Form 1099 accuracy may arise because the Form 1099 rules authorize brokers to make certain assumptions about tax elections made by their customers. Where these assumptions are not consistent with the actual tax elections made by the customer, amounts shown on the Form 1099 may vary from those the customer is required to report on his or her tax return. This guide includes recommendations for dealing with some of these variations.

Certain taxpayers, such as banks and securities dealers, are subject to special rules that generally lessen the impact of the bond premium and market discount rules. This guide focuses on debt investors—taxpayers who hold Bonds as capital assets.

[1] All references herein to "section" or "Tax Code" refer to the Internal Revenue Code of 1986, as amended, and all references to "Reg. section" are to the regulations issued thereunder.

Bond premium amortization

The bond premium rules address situations in which a Bond holder has purchased a debt instrument at a price that exceeds a baseline amount. The baseline amount is the amount of all remaining payments other than qualified stated interest (QSI). At purchase of the Bond, the amount of the bond premium is the excess of the purchase price over this baseline amount.[2] This baseline amount often, but not always, is equal to the Bond's stated principal amount (which is often known as its face amount or par value). QSI is interest that is unconditionally payable (in cash or other property other than debt of the issuer) annually or more frequently over the term of the Bond at a fixed or qualified variable rate.[3]

For taxable Bonds, applying the bond premium rules is elective. For tax-exempt Bonds, however, applying the bond premium rules is mandatory.[4]

A Bond holder who acquired a taxable Bond with bond premium and has not previously elected to amortize bond premium may either (1) elect to amortize the premium over the term of the Bond and, correspondingly, reduce the basis in the Bond by such amortization, or (2) make no election and include the full amount of the premium in the tax basis of the Bond. Where amortization applies, bond premium is amortized using the constant yield method (also known as the constant interest rate method).[5]

To make the bond premium amortization election for taxable Bonds, the taxpayer must offset the annual bond premium amortization amount against the QSI from each Bond acquired with bond premium.[6] A statement drawing attention to the election should be attached to the return; a sample statement is provided below. The statement, however, neither effects nor affects the election.[7] The election to amortize bond premium applies to all taxable Bonds with bond premium held at the beginning of the taxable year to which the election applies, and all Bonds acquired thereafter[8]. The election is revocable with the consent of the IRS,[9] and the IRS has provided an automatic consent procedure for revoking this election.[10]

Because bond premium amortization is mandatory for tax-exempt Bonds, a Bond holder who has acquired a tax-exempt Bond with bond premium must amortize the premium over the term of the Bond, reducing the basis in the Bond by such amortization.[11] If tax-exempt Bonds are held to maturity and their principal repaid in full, the Bond holder generally recognizes no gain or loss, as any premium has been fully amortized. If the Bond holder sells or disposes of tax-exempt Bonds before maturity, gain or loss may be recognized with reference to the difference between (a) the proceeds received and (b) the sum of the Bond holder's original purchase price plus all amortized premium to date. Failing to amortize the bond premium and retaining it in tax basis to reduce gain or increase loss on sale or disposition of a tax-exempt Bond is not permitted.

Questions regarding a taxpayer's amortization of bond premium

The following questions are intended to help assist a taxpayer in determining whether to elect to amortize bond premium, making the election, and addressing certain issues to be aware of with regard to bond premium amortization reporting by brokers.

Typically, it is in a Bond holder's interest to elect to amortize bond premium on taxable Bonds, because making the election may result in the Bond holder reporting less ordinary income while holding the Bonds, and less capital loss (or more capital gain) upon sale, disposition or redemption of the Bond if the taxpayer holds the Bond as a capital asset.

---

[2] Section 171(b)(1), Reg. section 1.171-1(d)(1).
[3] Reg. section 1.1273-1(c).
[4] Section 171(a), 171(c)(1), Reg. section 1.171-1(c).
[5] Section 171(b)(3), Reg. section 1.171-2.
[6] Reg. section 1.171-4(a)(1).
[7] *See id*.
[8] Reg. section 1.171-4(b).
[9] Section 171(c)(2), Reg. section 1.171-4(d).
[10] Rev. Proc. 2016-29 section 5.01.
[11] Section 1016(a)(5), Reg. section 1.1016-5(b)(3).

1. **Does the taxpayer's investment portfolio include Bonds?**
   a. If no, you need not answer the remaining questions. However, you may need to review the taxpayer's investment portfolio each year to answer this question.
   b. If yes, see question 2.

2. **Were the Bonds in the taxpayer's portfolio acquired with bond premium? As noted above, bond premium is equal to the excess of the Bond purchase price over a baseline amount—the amount of all remaining payments, other than QSI. This baseline amount often, but not always, equals the Bond's stated principal amount (which is often known as its face amount or par value).**
   a. If no, see the questions below relating to Bonds purchased at a discount.
   b. If yes, see question 3.

3. **Were some tax exempt Bonds acquired with bond premium (i.e., is interest on some of the Bonds excluded from income under section 103)?**
   a. If no, see question 4.
   b. If yes, amortizing bond premium on the tax-exempt bonds is mandatory, not elective. The bond premium amortization must be applied as an offset to tax-exempt interest income, and the tax basis of the Bond reduced by the annual amortization amounts. Brokers generally are required to report the annual amount of premium amortization as a reduction to tax-exempt interest income and adjust the basis for such amortization annually if the Bond was acquired after Dec. 31, 2013 (or in some cases, a later date).[12] Bond premium amortization is computed using the constant yield method (also known as the constant interest rate method).
   Be aware: You should consider state taxation of tax-exempt bond interest and bond premium. The interest from those Bonds may be subject to state income tax. In addition, certain states may not require (or permit) amortization of bond premium on tax-exempt bonds.
   Next, see question 4.

4. **Were some taxable Bonds acquired with bond premium (i.e., is interest on some of the Bonds not excluded from income under section 103)?**
   a. If no, there is no need to consider the election to amortize bond premium.
   b. If yes, see question 5.

5. **Has the taxpayer previously elected to amortize bond premium?**
   a. If no, see question 6.
   b. If yes, the taxpayer must continue to amortize bond premium for all Bonds (unless the taxpayer revokes the election, as noted above). Bond premium amortization is computed using the constant yield method (also known as the constant interest rate method). The bond premium amortization is applied as an offset to interest income and the tax basis of the Bond is reduced by the annual amortization amounts.[13] Brokers generally are required to report the annual amount of premium amortization as a reduction to interest income and adjust the basis for such amortization annually if the Bond was acquired after Dec. 31, 2013 (or in some cases, a later date).[14]
   c. Next, see question 9.

6. **What is the effect of making the election to amortize bond premium on taxable bonds?**
   a. Amortizing premium on taxable bonds offsets a ratable portion of the taxable QSI from such bonds each year, thereby reducing taxable income.
   b. The basis of the taxable bond must be reduced to account for the amount amortized each year.
   c. The adjustment to cost basis for the amortization of premium impacts potential gain or loss upon disposition of the Bond (generally capital gain or loss if the taxpayer holds the Bond as a capital asset).
   d. The overall effect typically is to decrease interest income while holding the Bond and later recognize a reduced capital loss (or increased capital gain).
   e. If taxable Bonds are held to maturity and their principal paid in full, the Bond holder generally would recognize no gain or loss, as any premium would be fully amortized. If the Bond holder instead disposes of the Bonds before maturity, gain or loss may be recognized with reference to

---

[12] Reg. section 1.6045-1(n)(7)(ii)(B) (for effective date, *see* Reg. sections 1.6045-1(a)(15)(i)(C) and 1.6045-1(n)(2)).
[13] Section 171(e), Reg. section 1.171-2(a)(1); section 1016(a)(5), Reg. section 1.1016-5(b)(1).
[14] Reg. sections 1.6049-9(b), 1.6045-1(n)(7)(ii)(A).

the difference between (a) the proceeds received and (b) the sum of the Bond holder's original purchase price plus all amortized premium to date.

f. The election is irrevocable without IRS consent (the IRS has provided an automatic consent procedure, as noted above), and applies to all taxable Bonds held at the beginning of the taxable year to which the election applies and all Bonds acquired thereafter.
g. Next, see question 7.

7. Does the taxpayer wish to make an election to amortize taxable bond premium?

a. If no, the taxpayer cannot offset annual taxable bond premium amortization against QSI from those Bonds.
   Be aware: For taxable bonds purchased at a premium after Dec. 31, 2013 (or, for certain types of Bonds, after a later date), brokers generally are required to report income on those Bonds as though the taxpayer has elected to amortize the premium and adjust the basis of those Bonds for the amount of premium amortization. This is true regardless of whether the taxpayer made the election. However, the taxpayer can notify the broker before the end of the taxable year that they are not making the election and request that the amortization not be calculated.[15]
   Be further aware: The taxpayer cannot treat the amortization as an offset to QSI unless you have made the election to do so. Regulations require brokers to report as though their customer has made the election to amortize bond premium for taxable Bonds acquired after Dec. 31, 2013 (or, in some cases, a later date), absent communication by the customer to the broker to the contrary.
b. If yes, see question 8.

8. The taxpayer has decided to elect to amortize taxable bond premium. How is the election made?

a. The election is made by offsetting annual amortization of bond premium against the QSI from each such Bond.
   Be aware: There are exceptions to this treatment listed below in *Exceptions to the General Rule on Amortization of Bond Premium*. Be further aware: Once made, the election applies to all taxable Bonds held by the taxpayer on the first day of the tax year for which it is made and all taxable Bonds acquired thereafter. Revoking the election requires consent of the IRS and the IRS has provided an automatic consent procedure.
b. **Be aware:** A Bond holder should also attach a statement to the federal income tax return for the tax year in which the election is made. A sample statement is shown below. The statement neither effects nor affects the election. It does, however, generally make clear to anyone reading the return that the taxpayer elected on the return to amortize taxable bond premium. As noted above, the election is actually made by offsetting the bond premium amortization against the QSI from the Bonds on the return.

9. What are some issues you may encounter related to taxable bond premium amortization?

a. **Issue: Reporting interest income net of taxable bond premium amortization.** For covered Bonds[16] (generally, Bonds acquired after Dec. 31, 2013), brokers report premium amortization regardless of whether the taxpayer has elected to do so (subject to the exception above where the taxpayer has otherwise notified the broker otherwise). Some brokers have been known to net interest income from such Bonds against that taxable period's amortization rather than report them separately. If the taxpayer has not made the election, be sure the taxpayer does not underreport interest income by using the netted figure from the Form 1099. **Recommendation:** Check the detail on the Form 1099 to determine the total reportable interest income.
b. **Issue: Underreporting of basis due to reported amortization without election.** Related to the issue described in 7a, above, some brokers will adjust basis on covered and non-covered Bonds[17] as though the premium was amortized and offset against interest income. This results in an underreporting of basis on the Bonds that could lead to reporting phantom capital gain or a smaller capital loss on the tax return and a potential overpayment of tax. **Recommendation:** Compare the original tax basis on taxable covered and non-covered Bonds to the basis reported upon disposition on the Form 1099 and realized gain/loss statement. If the election has not been

[15] Reg. section 1.6045-1(n)(5)(ii)(A).
[16] Covered Bonds generally are Bonds acquired after Dec. 31, 2013, except that for certain more complex debt instruments are covered Bonds only if acquired after Dec. 31, 2015. Reg. sections 1.6045-1(a)(14)(ii), -1(a)(14)(ii), -1(a)(15)(i)(E), -1(a)(15)(i)(D), -1(n)(2)(i), -1(n)(3).
[17] Non-covered Bonds are Bonds that are not covered bonds. For an explanation of the term 'covered bonds,' see Note 15 above.

made, any adjustment made to the Bond's tax basis for amortization of taxable Bond premium may need to be reversed on Form 8949.

c. **Issue: Underreporting of cost basis on taxable Bonds subject to the election.** When the taxpayer has a portfolio comprised of both taxable covered Bonds and non-covered Bonds and makes the election to amortize bond premium, there have been a number of instances in which the broker adjusts cost basis as though the election was made at the time the Bonds were acquired rather than as of the beginning of the tax year in which the election was made. The underreported basis results in a loss of tax benefit to the taxpayer and possible over-reporting of income and payment of tax. **Recommendation:** Carefully track the basis on taxable Bonds to ensure the correct adjusted basis is reported when taxable Bonds subject to the election are sold or redeemed.
   Be aware: This can be costly to the taxpayer in terms of tax return preparation fees and time-consuming for the tax return preparer. It is a good practice to discuss this with the taxpayer set expectations regarding who will track the basis of taxable Bonds subject to the election.

d. **Issue: Commingling premium amortization on taxable and tax-exempt Bonds.** For portfolios that contain both taxable and tax-exempt Bonds, some brokers report the premium amortization for both on the bond premium line of the 1099-INT. **Recommendation:** Carefully examine the supporting statements to the 1099-INT to ensure amortization from tax-exempt Bonds is not used to offset taxable interest income.

e. **Issue: Non-reporting of bond premium amortization on non-covered Bonds on the face of Form 1099.** Form 1099 reporting of amortization of taxable covered Bonds and taxable non-covered Bonds. Some brokers are only reporting amortization of taxable covered Bonds on the face of the Form 1099 INT and are showing the amortization of taxable non-covered Bonds as supplemental information. **Recommendation:** Be sure to carefully review the supplemental information contained in the Forms 1099.

Exceptions to the general rule of amortization of bond premium

There are exceptions and limitations on the offset to interest income by bond premium amortization. You should be aware of the following:

To the extent the amount of bond premium amortization for any accrual period exceeds the QSI for the period, the difference may be deducted by individual Bond holders as a miscellaneous itemized deduction.[18] This miscellaneous itemized deduction is limited to the amount by which the total interest inclusions on the Bond in prior accrual periods exceeds the total bond premium offset against such interest in prior periods.[19] Any bond premium in excess of this limit is not deductible in the current year, but can be carried forward to the next period.[20]

- Any amount of bond premium attributable to the conversion feature of a convertible Bond is not deductible; bond premium amortization is not available for this amount.[21]
- There are additional rules that apply to the amortization of premium on variable-rate debt instruments, inflation-indexed instruments, and Bonds subject to contingencies (including contingent payment debt instruments).[22]

Bond discount: Original discount and market discount

The term 'discount Bond' generally describes a fixed-income instrument issued or sold at a price lower than its stated maturity value. The attractiveness of a discount Bond to investors is enhanced by the expectation of receiving more at maturity than the investment made upon purchase. Discount Bonds exist in two general forms: market discount Bonds and original issue discount (OID) Bonds.

[18] Section 171(a)(1), Reg. section 1.171-2(a)(4)(i)(A).
[19] *Id*.
[20] Reg. sections 1.171-2(a)(4)(i)(B) and -2(a)(4)(i)(C).
[21] Section 171(b)(1), Reg. section 1.171-1(e)(1)(iii).
[22] Reg. section 1.171-3.

OID bonds and OID accrual

OID Bonds generally are issued at a discount to their maturity value. These include, but are not limited to zero-coupon Bonds (debt instruments that do not require any interest payments until maturity). A Bond's OID is the excess of the stated redemption price at maturity over the issue price.[23] The stated redemption price at maturity is often equal to the Bond's stated principal amount (often known as its face amount or par value), but this is not necessarily the case. Federal tax rules define the stated redemption price at maturity as all payments provided by the obligation other than QSI.[24] As noted above, QSI is interest that is unconditionally payable (in cash or other property other than debt of the issuer) annually or more frequently over the term of the Bond at a fixed or qualified variable rate.

Holders of OID Bonds generally must accrue OID each year into income for federal income tax purposes, applying the constant interest rate method of accrual (also known as the constant yield method).[25] This is true regardless of whether the Bond holder uses an overall cash or accrual method of accounting.[26] The accrued OID is ordinary interest income.[27] The Bond holder's tax basis in the Bond is increased by the amount of accrued OID included in the Bond holder's income.[28]

The bond premium rules apply to OID Bonds in the same manner as they apply to Bonds without OID. There is an additional set of premium rules, the acquisition premium rules, that may apply to OID Bonds but do not apply to Bonds without OID. The purchase of an OID Bond carries acquisition premium if the purchase price is (a) greater than the Bond's adjusted issue price, but (b) less than or equal to the sum of all remaining payments excluding QSI.[29] Acquisition premium must be amortized as an offset to OID income – either using a fractional method (the default method) or by using the constant yield method (if the taxpayer elects to do so, however, this requires electing to treat all interest, including QSI, market discount, OID and *de minimis* OID as OID).[30] The acquisition premium rules do not apply to Bonds purchased with bond premium.[31] Bond purchases with acquisition premium occur less frequently than purchases with bond premium or market discount.

Questions regarding a taxpayer's OID bonds and acquisition premium

The following questions are intended to assist you on an annual basis in accounting for OID income.

1. **Does the taxpayer's investment portfolio include Bonds?**
   a. If no, you need not answer the remaining questions. However, you may need to review the taxpayer's portfolio each year to answer this question.
   b. If yes, see question 2.

2. **Did any of the Bonds in the taxpayer's portfolio have OID?**
   a. If no, see the questions above related to Bonds purchased with bond premium and those below relating to Bonds purchased at a market discount.
   b. If yes, the taxpayer generally must report the amount of OID that accrued on the OID Bonds based on the constant yield method and include the accrued OID in income. This is true regardless of whether the OID Bonds are taxable or tax-exempt. The taxpayer's tax basis in the Bond is increased by the amount of OID included in income.[32] OID on tax-exempt Bonds is tax-exempt interest income.
   Be Aware: OID on tax-exempt Bonds may be includible in income for state income tax purposes.

---

[23] Section 1273(a)(1).
[24] Section 1273(a)(2), Reg. section 1.1273-1(b).
[25] Sections 1272(a)(1), 1272(a)(3), Reg. sections 1.1272-1(a), -1(b).
[26] Section 1272(a)(1), Reg. section 1.1272-1(a).
[27] Reg. section 1.1272-1(a).
[28] Section 1272(d)(2), Reg. section 1.1272-1(g).
[29] Section 1272(a)(7)(B)(i), Reg. section 1.272-2(b)(3).
[30] Section 1272(a)(7), Reg. sections 1.1272-2(b)(4)-(5) and 1.1272-3.
[31] The OID rules generally do not apply to bonds issued at a premium, *see* section 1272(c)(1), Reg. section 1.1272-2(a).
[32] Reg. section 1.1272-1(g) (tax basis is increased by the amount of OID accrued in income and decreased by payments made to the holder other than payments of QSI). See also section 1288(a) (tax-exempt Bonds). For special basis rules applicable to pro rata prepayments, *see* Reg. section 1.1275-2(f).

3. **Did any of the OID Bonds in the taxpayer's portfolio have acquisition premium? (The purchase of an OID Bond carries acquisition premium if the purchase price is (a) greater than the Bond's adjusted issue price, but (b) less than or equal to the sum of all remaining payments excluding QSI.)**
    a. If no, see the questions above related to Bonds purchased with bond premium and those below relating to Bonds purchased at a market discount.
    b. If yes, acquisition premium must be amortized as an offset to OID income – either using a fractional method (the default method) or by using the constant yield method if the taxpayer (if the taxpayer elects to do so). The acquisition premium rules do not apply to Bonds purchased with bond premium. Brokers are required to report amortization of acquisition premium on Bonds acquired after Dec. 31, 2013, as well as adjust the cost basis for the related amortization.[33] Note: A broker cannot take the election to treat all interest as OID into account for Form 1099 reporting purposes for Bonds acquired after Dec. 31, 2014.[34] As a result, Bond holders who have made that election generally will report acquisition premium amounts that differ from amounts that may be shown on Forms 1099 they have received.
    c. Also consider the questions above related to Bonds purchased with bond premium and those below relating to Bonds purchased at a market discount.

Market discount bonds and market discount accrual

The market discount rules address situations where a Bond holder has purchased a debt instrument after its initial issuance at a price that is less than the Bond's adjusted issue price (AIP). The market discount is the excess (if any) of the Bond's AIP over the purchase price.[35] A Bond's AIP is often equal to its stated principal amount (often known as its face amount or par value), but this is not necessarily the case. A Bond's AIP is its issue price on the day it was issued plus all accrued OID to date, minus all payments on the Bond to date, other than payments of QSI.[36]

For both tax-exempt and taxable Bonds, market discount is not includible in income by a taxpayer before the sale or disposition of the Bond (or receipt of a principal payment), unless an election is made to do so. The election to include market discount accrual in current income is addressed at the end of this section.

When a taxpayer sells or otherwise disposes of a market discount Bond, the gain generally is treated as ordinary interest income to the extent it does not exceed the accrued market discount at the date of disposition.[37] Receipt of a principal payment generally is treated as a disposition for this purpose.[38] Only gain in excess of the amount of the accrued market discount may be treated as capital gain where this rule applies.

Where there is a tax-free disposition of Bonds carrying market discount, such as an exchange of the Bond in certain types of corporate reorganizations, the ordinary income re-characterization potential inherent in the market discount generally is carried over in the property the taxpayer receives in exchange for the Bond.[39] In some circumstances, however, immediate recognition of the accrued market discount is required. This guide does not further address tax-free dispositions of market discount Bonds.

For market discount, the default rule is to accrue the discount using a ratable or straight-line method resulting in an equal amount of accrual annually while the taxpayer holds the Bond.[40] An alternative accrual method may be used: accruing the market discount using a constant interest rate method.[41] Use of the constant interest rate method results in accrual of less market discount in earlier years and more in later years as the Bond approaches maturity. In other words, market discount accrues more slowly using the constant interest method than it does using the ratable (straight-line) method. If the Bond is sold or otherwise disposed of prior

[33] Reg. sections 1.6049-9(c) and 1.6045-1(n)(7)(iii).
[34] *Id*.
[35] Section 1278(a)(2).
[36] Reg. sections 1.1275-1(b) (defining adjusted issue price) and 1.1273-1(c) (defining qualified stated interest).
[37] Sections 1276(a)(1) (ordinary character) and 1276(a)(4) (treatment as interest for many (but not all) purposes under the Code).
[38] Section 1276(a)(3)(A).
[39] Section 1276(c).
[40] Section 1276(b)(1).
[41] Section 1276(b)(2).

to maturity, a taxpayer would recognize a lower amount of ordinary income if it elects to use the constant rate method than it would if it makes no election and uses the ratable method.

Deduction of interest paid or incurred to purchase or carry a market discount Bond generally is deferred to the extent of the accrued unrealized market discount on the Bond.[42] The deferred interest deductions generally are allowed later when the market discount is recognized.[43]

Under exceptions expressly provided in the Tax Code, the market discount rules do not apply to: (1) short-term instruments (instruments with a term of one year or less),[44] (2) United States savings bonds,[45] and (3) tax-exempt Bonds purchased before May 1, 1993.[46] There are other situations where the market discount rules may be inapplicable. For example, where the Bond holder has acquired a Bond at a discount while the Bond is in default and full payment is due, applying the market discount rules would involve computing amortization by dividing the market discount by zero;[47] which mathematically cannot be done. This guide does not further address potential inapplicability of the market discount rules.

Questions regarding the election to accrue market discount using the constant interest rate method

The following questions are intended to assist you on an annual basis in determining if a need exists to consider making an election to accrue market discount on the constant interest rate method. The questions are intended to assist in considering and making the election to accrue discount on the constant interest rate method and include potential issues to be aware of with regard to market discount accrual reporting by brokers. A sample election statement is also included.

It is typically in a Bond holder's interest to elect to use the constant interest rate method of accruing market discount (rather than the default ratable method), because a Bond holder making the election generally would report less ordinary income and more capital gain upon a sale or disposition of the Bond at a gain prior to maturity.

1. **Does the taxpayer's investment portfolio include Bonds?**
    a. If no, you need not consider the remaining questions. However, you may need to review the taxpayer's portfolio each year to answer this question.
    b. If yes, see question 2.

2. **Were any of the Bonds acquired at a market discount? The market discount is the excess (if any) of the Bond's AIP over its purchase price. A Bond's AIP is often equal to its stated principal amount (often known as its face amount or par value), but this is not necessarily the case.**
    a. If no, please see the questions above regarding bond premium and OID.
    b. If yes, the taxpayer generally must report any gain on the disposition of these Bonds as ordinary income up to the amount of accrued market discount at the disposition date. The taxpayer must use the ratable (straight-line) method for amortizing market discount unless it has elected to either: (a) use the constant interest rate (constant yield) method or (b) include market discount in income currently as it accrues.
    c. Brokers generally are required to report the annual accrual of market discount assuming that their customer elected to use the constant interest rate method if the Bond was acquired after Dec. 31, 2014.[48] This is true regardless of whether the taxpayer has elected to use the constant rate method or not. The broker's reporting, however, does not affect the taxpayer's elections. Adjustments may therefore be necessary to account for differences between the broker's assumptions and the customer's actual tax elections. However, a taxpayer may notify its broker in

[42] Section 1277(a).
[43] Section 1277(b)(2).
[44] Section 1278(a)(1)(B)(i).
[45] Section 1278(a)(1)(B)(ii).
[46] Former section 1278(a)(1)(B), as in effect prior to the May 1, 1993, effective date of section 13206(b)(2)(a) of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).
[47] Section 1276(b)(1).
[48] Reg. section 1.6045-1(n)(11)(i)(B).

writing before the end of the calendar year that they are not making the constant interest rate method election and request that the ratable method continue to be used.[49] See question 5.

3. **What is the effect of making the election to accrue bond discount on the constant interest rate method?**
    a. Accruing market discount on the constant interest rate method results in lower accruals than the ratable method at first and greater accruals than the ratable method as the Bond approaches maturity.
    b. If the Bond is held to maturity and the Bond fully repaid, there is no difference in ordinary income recognition between the ratable and constant interest rate methods. However, if the Bond is sold at a gain prior to maturity, less ordinary income will be recognized using the constant interest rate method than the ratable method.
    c. The election can be made on a Bond-by-Bond basis or on a group basis.[50] Once made, the election is irrevocable.[51] This election should be considered each year for newly-acquired Bonds.
    d. Next, see question 4.

4. **Does the taxpayer wish to make an election to accrue discount on the constant interest rate method?**
    a. If no, you must use the ratable method of accruing bond discount.
    Be aware: For market discount Bonds purchased after Dec. 31, 2014 (or a later date for some Bonds), brokers generally are required to report discount on those Bonds as though their customer has elected to accrue such discount using the constant interest rate method. This is true regardless of whether the customer made the election (except where the customer has timely notified the broker that they have not made the constant interest rate election for accruing market discount).

    Be further aware: Taxpayers cannot treat the discount as accrued using the constant interest rate method unless they have made the election to do so. The broker's reporting, however, does not affect the taxpayer's elections. Adjustments may therefore be necessary to account for differences between the broker's assumptions and the customer's actual tax elections. If the taxpayer has not made the constant interest rate election, the taxpayer must use the ratable method to accrue market discount.
    b. If yes, see question 5.

5. **The taxpayer has decided to elect to accrue market discount on the constant interest rate method. How do I make the election?**
    a. The election is made by attaching to the taxpayer's federal income tax return a statement identifying the Bond(s) to which the election applies.[52] This election may also be made for one or more specific Bonds, or for a class or group of Bonds. Making the election for a class or group of Bonds may be more efficient than preparing separate election statements for specific Bonds. *See* the sample section 1276(b)(2) election statements below.
    Be aware: The election must be made no later than the extended due date for the earliest tax year for which the taxpayer must determine market discount.[53] Once made, the election applies to all Bonds identified in the election by the taxpayer on the first day of the tax year for which it is made. The election may be made for a class or group of Bonds, so it will apply to all market discount Bonds acquired thereafter that are included in the class or group.
    b. **Be aware:** A *de minimis* rule applies if the market discount is less than $^{1}/_{4}$ of 1 percent (0.25 percent) of the Bond's weighted average term to maturity (for Bonds with a principal amount payable only at maturity, this amount is the price payable at maturity multiplied by the number of complete years to maturity after the taxpayer acquires the Bond).[54] When the *de minimis* rule applies, there is no adjustment for accrued discount (as the market discount is deemed to be zero).

---
[49] *Id*.
[50] Section 1276(b)(2)(A), Rev. Proc. 92-67, sections 4.02 and 5.
[51] Section 1276(b)(2)(C).
[52] Rev. Proc. 92-67, sections 4.02 and 5.
[53] Rev. Proc. 92-67, sections 2.12, 3.01 and 4.01.
[54] Section 1278(a)(2)(C).

c. For issues to watch for related to the accrual of market discount, see question 6.

6. **What are some issues you may encounter related to market discount accrual and suggested solutions?**
    a. **Issue:** Differences arising between Form 1099 reporting and required tax return reporting. For many Bonds acquired after Dec. 31, 2014, brokers generally report market discount accrual on the constant interest rate method regardless of whether the taxpayer has elected to do so. As gain on the sale of a market discount Bond is treated as ordinary income to the extent of the accrued discount, use of the accrual on the constant interest rate method without the election would result in a misreporting of the ordinary income. **Recommendation:** Check the detail on the Form 1099-B and any realized gain/loss statement provided by the broker to determine whether the broker used the same method that the taxpayer uses. If the taxpayer has decided not to elect use of the constant interest rate method, the broker should be notified to utilize the default ratable method to avoid potential misreporting issues.

Election to include market discount accrual in current income

An election is available to include market discount accrual in income each year.[55] The inclusion of accrued market discount in income often provides no benefit to taxpayers, as it requires them to pick up additional income annually in exchange for the potential of less ordinary income recognition upon sale or redemption. Taxpayers who may wish to discuss the possibility of making the election to include the accrued market discount in income could include those with net operating losses or unused investment interest expense carryovers. In such cases, the taxpayer may be able to offset the accelerated ordinary income resulting from the election with a loss or investment interest expense deduction.

Questions regarding the election to include accrued market discount in income each year

1. **Does the taxpayer's investment portfolio include Bonds?**
    a. If no, you need not consider remaining questions. However, you generally should review the taxpayer's portfolio each year to answer this question.
    b. If yes, see question 2.

2. **Were any of the Bonds acquired at a market discount? The market discount is the excess (if any) of the Bond's AIP over the purchase price. A Bond's AIP is often equal to its stated principal amount (often known as its face amount or par value), but this is not necessarily the case.**
    a. If no, see the questions related to Bonds issued or purchased on the secondary market at a premium on page 1.
    b. If yes, see question 3.

3. **What is the effect of making the election to include accrued market discount in current year income?**
    a. Absent any elections, each year a portion of the market discount is accrued on a ratable basis, but not included in income. By making the election, taxpayers must include the annual accrual as ordinary interest income.[56]
    Be aware: If the taxpayer has also made the election to accrue market discount on the constant interest rate method, the amount includible in income each year will not be based on the ratable amount.
    b. Upon including market discount accrual in income, the basis of the Bond must be adjusted to account for the amount included in income each year (accretion).[57]
    c. The adjustment to cost basis for the annual accrual of market discount acts to reduce the potential ordinary gain recognized upon redemption or sale at a gain.
    d. The overall effect is to accelerate potential ordinary gain on redemption or disposition in exchange for capital gain/loss treatment at redemption or sale (assuming a gain).

[55] Section 1278(b).
[56] Section 1278(b)(1)(B).
[57] Section 1278(b)(4).

e. The election is only revocable with consent of the IRS and the IRS has provided an automatic consent procedure for revoking the election.[58]

Exhibit A: Sample statement regarding election to amortize bond pre

Statement Regarding the Taxpayer's Election to Amortize Bond Premium under Section 171(c)

Taxpayer Name:

Taxpayer Identification Number:

The taxpayer has elected on this tax return under section 171(c) of the Internal Revenue Code to amortize bond premium pursuant to Treasury Regulation section 1.171-4(a). The taxpayer has done so by offsetting amortization of bond premium against the qualified stated interest income from the applicable bond(s). Taxpayer is attaching this statement to the return as recommended by Treasury Regulation section 1.171-4(a).

Exhibit B: Sample election to use the constant interest rate method of accruing market discount for a single bond

Election to Use Constant Interest Rate Method under section 1276(b)(2) for One or More Specific Bonds

Taxpayer Name:

Taxpayer Identification Number:

Section 1276(b)(2) Election Statement

In accordance with Internal Revenue Code section 1276(b)(2) and Rev. Proc. 92-67, section 4, the taxpayer elects to use the constant interest rate method of accruing market discount on bonds. This election is effective for the following bonds:

Description(s) of Bond(s):
Date(s) Acquired:
Maturity Date:
Basis at Acquisition:
CUSIP Number If Applicable (optional):

Exhibit C: Sample election to use the constant interest rate method of accruing market discount for a group of bonds

Election to Use Constant Interest Rate Method under Section 1276(b)(2) for a Group of Bonds

Taxpayer Name:

Taxpayer Identification Number:

Section 1276(b)(2) Election Statement

In accordance with Internal Revenue Code section 1276(b)(2), and Rev. Proc. 92-67, section 5, the taxpayer elects to use the constant interest rate method of accruing market discount on bonds for the tax year ending (Month, Day, Year).

This election is effective for the following bonds:

[Describe the group(s) of Bonds. For example: all bonds issued at a market discount held in [Broker Name] account number [Account Number] (or successor account) or all bonds issued by [issuer name] and acquired by taxpayer.]

[58] Rev. Proc. 2016-29, § 30.01.