

The Application of the Market Discount Rules

Fixed income instruments that are purchased in the secondary market at a price less than their redemption or adjusted issue price are often referred to as “market discount” bonds. The “discount” is the difference between the amount paid to purchase the bond and its redemption price, or in the case of an OID instrument, its adjusted issue price. Original Issue Discount (OID) bonds trade with a discount that was part of the original issue pricing. However, if an OID bond trades below its adjusted issue price (the price that reflects the daily accrual of OID added to the original issue price), it too is considered trading with market discount.

Under the Cost Basis Regulations we are required to track bonds and adjust cost basis in accordance with appropriate sections of the Tax Code. Sections 1276 through 1278 apply to market discount bonds. These rules specify how market discount is to be calculated and recognized for tax purposes by a taxpayer. We have the responsibility to apply the market discount rules to your bonds based upon certain elections you make or defaults we apply.

The discounting of bonds in the secondary market is generally a result of increased interest rates. If interest rates are currently at ten percent (10%), those bonds that are paying lower rates would not be bought unless they can be purchased at a price that turns their stated interest rate into an approximate ten percent (10%) return. This happens by reducing the market price asked to a point where the lower stated interest rate would be equivalent to the current market rates. As a result of this market convention, the IRS takes the position that market discount is really interest to be earned over the remaining life of the instrument (from purchase date to redemption). Since it is considered interest, it is ordinary income, and not capital gain in nature.

Market discount is considered earned over the remaining life of the instrument from the date you purchased it. However, the Tax Code permits the taxpayer to elect not to recognize the market discount interest income currently but rather at the time of sale or redemption. We are required to give you the choice to elect either approach. If you choose to recognize market discount on a current basis this means you will receive a Form 1099-INT for a proportionate amount of the discount each year you hold the instrument. You will be required to pay taxes currently on this ordinary interest income. On the other hand, if you choose to defer income recognition until you dispose of the instrument, there is no current income subject to tax and you will not receive a Form 1099-INT. The Cost Basis regulations require that we default your choice to market discount deferral status as this is most advantageous for taxpayers. For you to recognize this income currently you must tell Hilltop by making a current recognition election.

Assuming you are using the default of non-current recognition, you will be required to recognize the total amount of market discount that has accrued from the day you purchased the security until the day you disposed of it, at the time of disposition. This is ordinary interest income, but you will not receive a Form 1099-INT. Rather, your form 1099-B for the disposition of the security will report the total accrued market discount in box 1f. You can then follow the instructions on Form 8949 with regard to presenting this amount on your personal income tax return as interest. It should be noted that all market discount recognized as income, whether currently or at disposition, will be added to the basis of your bond when you are figuring gain or loss.

Thus far we have explored the unique quality of a market discount bond that enables a taxpayer to postpone the recognition of current interest income until such time as the security is sold or otherwise disposed of. But there is an additional unique aspect that involves another election as well. The accruing of market discount on a bond can be calculated in one of two ways: Straight Line or Constant Yield.

The Straight Line accrual applies a constant dollar amount for each day the security is held over the life of the security. Thus if the discount were \$100 on a bond the straight-line method would divide that amount by the number of days to maturity and apply the quotient on a daily basis.

The Constant Yield calculation is based on a yield to maturity (YTM) calculation designed to make the daily accruals always arrive at the same interest rate percentage. This occurs by always paying the same interest rate on the ever increasing basis value. Thus, with a constant yield of ten percent (10%), accrual amounts will gradually increase as the basis value of the debt instrument is increased reflecting prior daily accruals. This Constant Yield approach maintains a steady interest rate and varies the payment amount rather than maintaining a steady payment amount and varying the daily interest rate as the Straight Line method does.

The Constant Yield method will always yield a lower amount of taxable ordinary income than the Straight Line method until the redemption day when the two methods will be equal to the amount of total market discount accrued on the bond. This means that the sale of a market discount bond prior to redemption should always be accompanied by an election for the Constant Yield method of accrual if a taxpayer sees a lower tax liability. Fortunately, cost basis regulations require brokers to default to this method if a customer has not elected otherwise.

In summary, you have the ability to delay paying taxes on market discount interest income by using the Hilltop default which recognizes income at time of sale. Further, by accruing on the constant yield method (Hilltop's default) you can also reduce the income on which you pay tax if you dispose of the bond prior to maturity.