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Bond Premium Carryforward Final Regs Provide Welcome Relief for Taxpayers.

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The final regs adopt the proposed (REG-140437-12) and temporary (T.D. 9609) regs, issued in January 2013, without substantive changes.

"I think this is welcome relief that fixes a mechanical problem under the bond premium rule," said Stevie D. Conlon of Wolters Kluwer Financial Services Inc.

Under the final regulations, a taxpayer making a section 171 election to deduct bond premium against interest received on the bond may now deduct remaining premiums against ordinary income in the final accrual period. Before the final regs, any carryforward bond premium not deducted at maturity would release, so the bond's basis was higher than its value, and the bondholder would have a capital loss.

"If you have a negative yield net of the bond premium, then you should be entitled to a corresponding ordinary loss," Conlon said.

Under reg. section 1.171-2(a)(4), the amount of bond premium amortization was calculated every year. When the bond premium amortization exceeded the interest received on the bond, the bondholder did not receive the amortization amount. Rather, the difference between the amortization and the interest received was carried forward to the next year.

Under the new rules, taxpayers can deduct only up to the amount of interest payments on the bond; however, they may deduct the excess carryforward upon the bond's maturity.

"Under reg. section 1.171-2(a)(4)(i)(A), bond premium in excess of qualified stated interest is deferred until later, so it's not optimal for taxpayers, but it's understandable," Conlon said. "At least you are getting ordinary instead of capital loss under this rule. So I think it's a very good finalization."

Conlon said that after 2008, interest rates became incredibly low. That led to many short-term, high credit quality loans that paid hardly any interest, which made the issue more important to portfolio advisers in recent years. "We were seeing this mechanical issue arise regularly in our analysis of debt instruments for cost basis reporting purposes," she said.

According to Conlon, the current interest rate environment is an aberration. "We can expect a rise in interest rates as the Federal Reserve moves away from quantitative easing," she said. The regs are particularly important in the current, low-rate environment, she explained, but they will be less so once interest rates rise.

Treasury originally released the bond premium carryforward regs in response to questions regarding Treasury inflation-protected securities. According to their preamble, the temporary regs were a response to inquiries regarding a holder’s treatment of a taxable zero coupon debt instrument acquired at a premium and with a negative yield.

by William R. Davis