

Bond Case Briefs

Municipal Finance Law Since 1971

Wash Sales Asymmetrically Affect Premium and Discount for Debt.

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In this report, Conlon discusses how to determine bond premium, original issue discount, and market discount for bonds that have been adjusted by wash sale losses.

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I. Overview

Bond premium, original issue discount, and market discount are determined by a bond's tax basis, not its purchase price. Under the wash sale rules, the basis of stock or securities (including bonds) that trigger a wash sale disallowance must, in effect, be adjusted by the amount of the disallowed wash sale loss.¹ This report discusses how to determine bond premium, OID, and market discount for bonds that have been adjusted by wash sale losses. As a matter of law, the answer is straightforward. As a matter of policy, the answer is inconsistent — and is not intuitive. Bond premium, OID, and market discount are tax rules that generally affect the timing and character of income recognized by investors holding debt instruments. Many aspects of these rules are complex and convoluted. As a result, holders of debt comply with the rules to significantly varying degrees of correctness, and IRS review of taxpayer compliance is difficult. The introduction of cost basis reporting for many types of debt instruments acquired on or after January 1, 2014, significantly changes the game. Now, brokers must apply these rules and track a customer's adjusted cost basis for cost basis reporting on Form 1099-B when the debt instruments are sold.² Brokers are also required to take into account some wash-sales-related basis and holding period adjustments in computing basis. As a result, whether these rules are also affected by wash-sale-related basis adjustments is topical.

A. Alternative Approaches for Wash Sales

There are three possible approaches: (1) Never adjust bond premium, OID, or market discount on the debt instrument that triggers a wash sale disallowance and basis adjustment (a wash-sale-triggering replacement debt instrument) for wash sales; (2) always adjust bond premium, OID, and market discount for wash sales; and (3) sometimes adjust bond premium, OID, and market discount for wash sales.

B. Conclusion Under Current Law

Existing law follows the third approach: sometimes adjusting bond premium, OID, and market discount for wash sales and sometimes not, depending on the timing of the wash sale loss and the timing of the purchase of the wash-sale-triggering replacement debt instrument. Existing law is inconsistent and is not intuitive, and produces asymmetrical results depending on whether the debt instrument triggering a wash sale disallowance is purchased before or after the date of the related wash sale.

In short, an adjustment to bond premium and market discount turns on whether a debt instrument triggering a wash sale disallowance is purchased before or after the date of the related wash sale.

II. Asymmetrical Debt Wash Sale Adjustments

If a taxpayer acquires a substantially identical debt security on or within 30 days after the date of the sale of a debt security at a loss (the acquisition of a post-wash-sale replacement security), the wash sale rule of section 1091 generally applies and the loss is deferred. The basis of the acquired post-wash-sale replacement security is essentially increased by the amount of the loss under section 1091(d).³ There is no tax law provision or guidance deferring this basis adjustment to a later date or treating this basis adjustment in any special fashion.⁴ The basis adjustment therefore appears to be immediate and occurs the instant the post-wash-sale replacement security is acquired, which changes the bond premium, OID, and market discount amounts. Conversely, the purchase price rather than the wash sale adjusted basis determines the amount of bond premium and acquisition premium adjustments for a substantially identical debt security acquired within 30 days before the date of the sale of a debt security at a loss (a pre-wash-sale replacement security). The reason is that the definitions of bond premium and acquisition premium are determined by reference to a security's initial tax basis, and the purchase price for a pre-wash-sale replacement security is the initial basis. The loss is disallowed and the basis of the pre-wash-sale replacement security is increased under section 1091(d), but bond premium, OID, and market discount amounts are unaffected. That is because the wash sale basis adjustment occurs as of the date of the wash sale, which would be a date *after* the date the pre-wash-sale replacement security is acquired, and bond premium, OID, and market discount would have been determined at the time of the security's acquisition.

A. Wash Sale Effect on Bond Premium Example

Figure 1. Asymmetrical Wash Sale Example



Because bond premium and acquisition premium (for purposes of determining the amount of OID a holder must take into account and the related basis adjustments for OID) are determined by reference to a security's initial tax basis,⁵ the wash sale adjusted basis for a post-wash-sale replacement security rather than its purchase price determines the amount of bond premium and acquisition premium adjustments. Therefore, bond premium and acquisition premium calculations for a post-wash-sale replacement security are based on the wash sale adjusted basis for that security rather than its purchase price. Market discount determinations are made in the same manner for a post-wash-sale replacement security (although there is no regulatory guidance under the market discount rules) because of both the clear statutory definition of market discount and the similarities between OID and market discount.⁶

III. Legal Framework and Analysis

A. Timeline of Critical Developments

The following table illustrates the timeline for the early development of the wash sale rules and the bond premium and market discount rules (the development of the acquisition premium definition under the OID rules is discussed in an appendix):

Tax Law

Timeline

1921:	Wash sale rules enacted
1924:	Wash sale basis adjusted (amendment to 1921 rule)
1939:	<i>Hanlin</i> (3d Cir.): Wash sale rule clearly applies to bonds
1942:	Bond premium rule enacted (section 125) with clear definition
1950:	<i>Korell</i> (U.S.): Bond premium definition is broad and includes conversion premium (bond premium rule amended to reverse <i>Korell</i>)
1984:	Market discount rules with definition enacted; definition of acquisition premium revised
1986:	Bond premium definition exception section 171(b)(4) added
1997:	Revised bond premium regulations issued in final form

B. Wash Sale Rule and Basis Adjustment Origin

In 1921 Congress enacted the original wash sale rule. It established a 61-day wash sale window: Taxpayers could not deduct losses on sales of securities if substantially identical securities were purchased at a loss within the period beginning 30 days before and ending 30 days after the date of the sale.⁷ Congress intended for the wash sale rule to merely defer rather than permanently disallow the losses, reasoning that the purchased security that triggered the wash sale rule was in essence substituted for the sold security.⁸ In 1924 a basis adjustment rule that more mechanically provided for deferral rather than disallowance was added, addressing the purchase of substantially identical securities at different prices and in different quantities.⁹ This basis adjustment rule is now set forth in section 1091(d). In 1932 Congress provided for the holding period of the sold securities to be tacked onto the holding period of the acquired substantially identical securities for purposes of determining whether gain or loss is short term or long term.¹⁰

The essence of the wash sale rule has remained unchanged since then, although the rule has been amended over time to expand and clarify its application to other financial instruments, including short sales, contracts to acquire securities, securities futures, and cash-settled contracts. The current wash sale rules do not apply to stock or securities dealers for losses sustained in the ordinary course of business. They also do not apply to stocks or securities that are marked to market under sections 475 or 1256,¹¹ or to stock or securities that are positions in a straddle.¹²

C. The Wash Sale Rule, Debt, and *Hanlin*

From the start, Congress applied the wash sale rule to both equity and debt. Although Congress was troubled by wash sales for stock, it described wash sales of bonds in legislative hearings. Before the enactment of the Revenue Act of 1921, Treasury's representative, appearing before the Senate Finance Committee, explained that if a taxpayer "changes from one form of Liberty bonds to another form of Liberty bonds, or sells United States Steel and buys New York Central, he can take his loss under this provision."¹³

In *Hanlin*,¹⁴ the Third Circuit, applying the wash sale rule in section 118(a) of the Revenue Act of

1932, held that several combinations of buys and sells of municipal bonds and Federal Land Bank bonds, respectively, were wash sales of substantially identical securities (with some exceptions). In one of the transactions held to be a wash sale, the “taxpayer sold \$125,000 par value City of Philadelphia bonds, issued in 1918, maturing in May and November, 1948, and on the same dates purchased at the same unit prices \$125,000 par value City of Philadelphia bonds, issued in 1919, maturing on March 1, 1949.”¹⁵ The court discussed the meaning of the term “substantially identical” and its application to debt of the same issuer but with different maturity dates.¹⁶

D. Definition of Bond Premium Origin

The concept of bond premium was established for book/financial accounting purposes many years before federal income tax law on bond premium existed.¹⁷ In 1942 Congress enacted specific tax legislation mandating the amortization of bond premium for tax-exempt municipal bonds and permitting taxpayers to elect to amortize bond premium on taxable bonds.¹⁸

The legislative history contemporaneous with the enactment of the bond premium rule defines bond premium for tax purposes as follows: “Bond premium, in the case of any bond subject to this section, is the total premium thereon; that is, the excess of the basis of the bond for determining loss over the amount payable at maturity.”¹⁹

The definition of bond premium is precise — basis, rather than fair market value or other economic or financial accounting measures, is used to determine the amount of bond premium for tax purposes. The definition of basis, which is a tax term of art, was clearly understood and addressed explicitly in several other critical code sections back in 1942 when this new provision was enacted.²⁰ More importantly for purposes of our analysis here is that the wash sale rule was already law (having been enacted in 1921) and already provided for an adjustment to basis (amended to do so in 1924) under section 118(a) of the 1939 code.

E. Supreme Court and Bond Premium: *Korell*

The Supreme Court specifically addressed the scope of the definition of bond premium under section 125 in 1950 in *Korell*.²¹ The IRS argued in that case that bond premium associated with a bond conversion privilege was not the sort of bond premium that the taxpayer should be able to amortize. The Court disagreed, holding for the taxpayer: “We reject this argument as inapposite to the structure of the statute, unsupported by the legislative history and inconsistent with the normal use of the term ‘bond premium.’” The Court added:

- We cannot reject the clear and precise avenue of expression actually adopted by the Congress because in a particular case we may know, if the bonds are disposed of prior to our decision, that the public revenues would be maximized by adopting another statutory path.

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Congress reacted unfavorably to the Supreme Court’s decision and immediately amended section 125 to prohibit taxpayers from amortizing bond premium relating to conversion features.²³ *Korell* is particularly relevant here. It can be read as stating that the statutory language of the bond premium rule (as enacted in 1942) and related legislative history clearly define bond premium broadly by direct reference to basis. The definition is not narrowed by external views or opinions about what does and does not constitute bond premium.²⁴

F. Antiabuse Concerns for Tax-Exempt Bonds

Another aspect of the bond premium rule that has been in place since its enactment in 1942 is the

mandatory amortization of bond premium for tax-exempt bonds to prevent the deduction of losses for premium associated with tax-exempt interest. As stated in the legislative history of the Revenue Act of 1942:

- Under existing law, bond premium is treated as capital loss sustained by the owner of the bond at the time of disposition or maturity and periodical payments on the bond at the nominal or coupon rate are treated in full as interest. The want of statutory recognition of the sound accounting practice of amortizing premium leads to incorrect tax results which in many instances are so serious that provision should be made for their avoidance.

The present treatment, moreover, results in an unjustifiable tax discrimination in favor of tax-exempt as against taxable bonds. Holders of taxable bonds not only pay a tax, as upon income, upon that portion of the so-called interest payments which is in reality capital recovered but are denied the deduction, except as restricted by the capital loss provisions, of the corresponding capital “lost” at maturity. Holders of tax-exempt bonds, on the contrary, are allowed to deduct premium as capital loss in spite of the fact that the corresponding amount of capital has been recovered in the guise of interest and no tax has been paid upon it.²⁵

During a series of questions by Sen. William Howard Taft in the 1942 Senate hearings, while Congress was deciding whether to enact the bond premium rule, there was specific focus on the legislation’s mandatory amortization of bond premium for tax-exempt bonds to prevent losses relating to bond premium. John O’Brien of the Office of Legislative Counsel, testifying on the Revenue Act of 1942 provisions, was questioned by Taft on the tax on gain but denial of loss:

- SENATOR TAFT. Speaking of municipal bonds, does he pay an income tax on that on the basis of buying at 90 and selling at 100; does he pay an income tax?

MR. O’BRIEN. Yes.

SENATOR TAFT. He never takes a loss if he buys that bond at 110 and sells at 100.

MR. O’BRIEN. I am not justifying it, but on the theory —

SENATOR TAFT. He is too well treated already.

MR. O’BRIEN. On the theory that the interest yield on the bond is what he bargained for at 110, and he didn’t bargain for a capital loss.²⁶

G. 1984 Enactment of Market Discount Rules

The market discount rules were set forth in sections 1276 through 1278 of the 1954 code and were enacted as part of the Deficit Reduction Act of 1984.²⁷ Section 1278(a)(2)(A) of the 1954 code provided:

- The term “market discount” means the excess (if any) of —
 - (i) the stated redemption price of the bond at maturity; over
- (ii) the basis of such bond immediately after its acquisition by the taxpayer.²⁸

There was also a de minimis rule set forth in section 1278(a)(2)(C) of the 1954 code.²⁹ Note that this statutory definition explicitly defines market discount in part as “the basis of such bond immediately after its acquisition by the taxpayer.” The relevant legislative history provides no guidance suggesting any limitation or alternative interpretation of the statutory definition of market discount.³⁰

H. Exchange Exception for Premium, Discount

The Tax Reform Act of 1986 made changes to the bond premium and market discount rules.³¹ Two amendments concerned the definitions of bond premium and market discount.³² It must be considered whether these amendments affect the analysis set forth above. Section 171(b)(4) of the bond premium rules as added in 1986 provides:

- (A) IN GENERAL. — If —
 - (i) a bond is acquired by any person in exchange for other property;
 - (ii) the basis of such bond is determined (in whole or in part) by reference to the basis of such other property; and
 - (iii) for purposes of applying this subsection to such bond while held by such person, the basis of such bond shall not exceed its fair market value immediately after the exchange. A similar rule shall apply in the case of such bond while held by any other person whose basis is determined (in whole or in part) by reference to the basis in the hands of the person referred to in clause (i).
- (B) SPECIAL RULE WHERE BOND EXCHANGED IN REORGANIZATION. — Subparagraph (A) shall not apply to an exchange by the taxpayer of a bond for another bond if such exchange is a part of a reorganization (as defined in section 368). If any portion of the basis of the taxpayer in a bond transferred in such an exchange is not taken into account in determining bond premium by reason of this paragraph, such portion shall not be taken into account in determining the amount of bond premium on any bond received in the exchange.

Similarly, section 1278(a)(1)(D)(iii) and (iv) of the market discount rules provides:

- (iii) BONDS ACQUIRED IN CERTAIN REORGANIZATIONS. — Clause (i) shall not apply to any bond issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1)) in exchange for another bond having market discount. Solely for purposes of section 1276, the preceding sentence shall not apply if such other bond was issued on or before July 18, 1984 (the date of the enactment of section 1276) and if the bond issued pursuant to such plan of reorganization has the same term and the same interest rate as such other bond had.
- (iv) TREATMENT OF CERTAIN TRANSFERRED BASIS PROPERTY. — For purposes of clause (i), if the adjusted basis of any bond in the hands of the taxpayer is determined by reference to the adjusted basis of such bond in the hands of a person who acquired such bond at its original issue, such bond shall be treated as acquired by the taxpayer at its original issue.

Congress intended to address perceived abuses in which taxpayers had used exchange transactions to essentially transfer basis from other assets (such as equity interests in various types of entities) into distributed debt instruments in order to pump up the basis in the debt and respectively increase the amount of amortizable bond premium and reduce the net amount of potential ordinary interest income.³³ This rule does not appear applicable to wash-sales-related basis adjustments because the term “other property” in that context appears to reference property other than bonds or debt instruments. Further, wash sales generally arise in sales rather than exchanges, and the use of the term “exchange” in this special rule appears to focus on exchanges involving two different taxpayers or persons (such as an entity and a holder of an equity interest in that entity) rather than the same taxpayer.³⁴ This limitation in scope appears consistent with the language of reg. section 1.171-1(e)(2), which limits this test to cases in which “the bond is transferred basis property (as defined in section 7701(a)(43)) and the transferor had acquired the bond at a premium.” Section 7701(a)(43) defines transferred basis property as “property having a basis determined under any provision of

subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.” The legislative history regarding this rule, which is scant, does not suggest a broader purpose.³⁵ Moreover, the term “exchange” does not appear to encompass sales.³⁶

I. Updated Definition of Bond Premium

In 1997 the IRS finalized new bond premium regulations that addressed several substantive issues resulting from the 1986 legislation that changed bond premium amortization from ratable to constant yield (similar to the constant yield accruals of OID) and various other changes, including the enactment of section 171(b)(4) regarding the determination of the amount of bond premium for bonds acquired in specified exchanges.³⁷ The definition of bond premium in the proposed version of the regulations was generally noncontroversial and was adopted with relatively few changes.³⁸ Set forth here is the general 1997 final bond premium regulation definition:

- A holder acquires a bond at a premium if the holder’s basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments of qualified stated interest).

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The 1997 final bond premium regulations also address the special rule for determining bond premium that was discussed above under section 171(b)(4) for specified exchanges:

- If the holder acquired the bond in exchange for other property (other than in a reorganization defined in section 368) and the holder’s basis in the bond is determined in whole or in part by reference to the holder’s basis in the other property, the holder’s basis in the bond may not exceed its fair market value immediately after the exchange. See paragraph (f) Example 1 of this section. If the bond is acquired in a reorganization, see section 171(b)(4)(B).

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Consistent with the discussion above that the special exchange rule was focused on exchanges of equity interests (such as partnership interests) for debt instruments, referenced Example 1 in the regulation addresses a partnership interest for debt exchange.⁴¹

J. State of the Rules Today

The final regulations defining bond premium were published in 1997. No comments were received or IRS pronouncements made that provide any relevant limitation on the clear language of the regulations.⁴²

IV. Additional Considerations

A. Is There an Unfair Benefit to Taxpayers?

The wash sale adjustments are mechanical. But are they sensible?⁴³ The wash sale rule effectively prevents a taxpayer from taking a tax loss for a disposition in connection with a stock or security if the taxpayer acquires a substantially identical security within the 61-day window.⁴⁴ The related basis adjustment rule results in a timing difference by increasing the basis of the replacement security. That adjustment essentially makes the wash sale a deferral of loss rule rather than a permanent disallowance of loss rule. As discussed previously, Congress believed that the purchased security that triggered the wash sale rule was in essence substituted for the security sold.⁴⁵ Does the wash sale adjustment also permit the conversion of amounts that would ordinarily result in capital loss into adjustments that reduce ordinary interest income, OID, or the potential amount of market discount ordinary income? This conversion, arguably, is inappropriate.

For example, consider a taxpayer (who has elected to amortize bond premium on taxable bonds) who purchases a \$100 principal amount taxable corporate bond at a price of \$110. Assume that the taxpayer sells that bond on the date her basis has been adjusted to \$106 (because of the amortization of bond premium) at a sales price of \$102, followed by her immediate purchase the next day of an identical bond at a purchase price of \$102. Because the purchase of an identical bond one day after the sale of the first bond⁴⁶ at a loss triggers a wash sale, the taxpayer's \$4 loss on that sale is deferred, and her basis in the later-purchased bond is increased from the purchase price of \$102 to \$106 because of the wash sale basis adjustment. If the taxpayer takes the \$4 wash sale basis adjustment into account in amortizing bond premium on the subsequently purchased bond and that bond is held to maturity, she could be considered to have converted a \$4 capital loss into an additional \$4 of bond premium amortization, generating adjustments that offset or reduced \$4 of taxable interest income on that bond. This could be considered an abusive conversion of capital losses into ordinary deductions that reduce taxable interest income.

However, the inclusion of the wash sale basis adjustment approximates the correct tax result for a taxpayer who holds a bond over a longer period of time. To begin, the bond premium rule itself is in essence a legislatively approved conversion rule. The bond premium rule could itself be considered a permitted conversion that is subject to an important condition: *that the taxpayer holds the bond over a period of time*.

Consider this example: A taxpayer buys a \$100 face amount bond at a premium price of \$110. The \$10 is bond premium. If market rates change overnight and the taxpayer sells the bond the very next day at a new market price of \$102, she is entitled to an \$8 capital loss on the sale. However, if the taxpayer holds that bond until it matures, the entire \$10 bond premium is amortized and offsets taxable interest on the bond, and the bond matures at no gain or loss. Did holding the bond to maturity permit an abusive conversion of capital losses into ordinary deductions? No, in my view.

In a somewhat similar vein, if a transferor receives a bond that was purchased by a decedent at \$102 and the initial basis in that bond is increased from \$102 to \$106 because the FMV of that bond on the date of death was \$106, is the transferor permitted to amortize \$6 of bond premium (rather than \$2)? Is the amortization of the step-up basis adjustment an inappropriate conversion of potential capital loss into ordinary deductions? Again — no; in my view, taking into account the basis step-up in computing bond premium is appropriate, both as a matter of law and policy.

Consistent with the principle that the wash sale rule is a deferral rule rather than a permanent disallowance rule, the inclusion of the wash sale basis adjustment in determining the amount of bond premium, acquisition premium, and market discount on the wash-sale-triggering replacement debt instrument that is not a tax-exempt bond could be considered a continuation of the time-value-of-money-related adjustments that the taxpayer could have continued to have been permitted (or required) to make if she had continued to hold the debt instrument that generated the wash sale loss.⁴⁷

B. Considerations for Tax-Exempt Bonds

Now let's consider whether there is a tax avoidance concern in the context of tax-exempt bonds. Assume a taxpayer purchases a \$100 principal amount tax-exempt bond at a price of \$110. Assume she sells that bond on the date her basis has been adjusted to \$106 (because of the mandatory amortization of bond premium for tax-exempt bonds) at a sales price of \$102. And assume that she immediately purchases an identical bond the next day at a purchase price of \$102. Because the purchase of an identical bond one day after the sale of the first bond at a loss triggers a wash sale, the taxpayer's \$4 loss on that sale is disallowed, and her basis in the subsequently purchased bond is increased from the purchase price of \$102 to \$106 because of the wash sale basis adjustment.

Figure 2Mandatory Amortization of Bond Premium Debt Held to Maturity



Assume that the wash sale basis adjustment was not taken into account for purposes of computing the amount of bond premium on the wash-sale-triggering replacement debt instrument. If the \$4 wash sale basis adjustment were ignored for purposes of computing the amount of bond premium on that replacement debt instrument and the taxpayer held the debt instrument to maturity, she would have amortized \$2 of bond premium. However, under this hypothetical case, her basis in the tax-exempt bond would be \$104 at maturity (because the bond premium regulations acknowledge that a debt instrument's basis for purposes of computing gain or loss can differ from the amount used for purposes of computing bond premium). The receipt of \$100 on maturity for that bond would generate a capital loss, a result that seems clearly at odds with the congressional concern evidenced in the floor debate in 1942 when the bond premium rules were enacted.⁴⁸ For this reason, in the case of a tax-exempt bond, the inclusion of the wash sale basis adjustment in determining bond premium, acquisition premium, and market discount on the wash-sale-triggering replacement debt instrument could be considered necessary to prevent the allowance of tax losses at maturity.

C. Should the Law Be Changed?

The explicit statutory definitions for bond premium and market discount and their references to basis rather than purchase price clearly require taking wash sale basis adjustments into account for post-wash-sale replacement securities.⁴⁹ And the failure to do so could result in capital losses on the maturity of tax-exempt bonds — which is contrary to long-standing tax policy concerns based on the bond premium rules. Further, that treatment is consistent with the general effect of inheritance-related basis adjustments on recipients of debt instruments distributed upon a taxpayer's death.

However, taking into account wash sale basis losses for purposes of bond premium, acquisition premium, and market discount turns on when the taxpayer acquired the replacement bond (because wash sale basis adjustments do not affect those calculations for pre-wash-sale replacement securities), which permits taxpayer selectivity. And the differing outcomes raise tax policy concerns.

Figure 3Mandatory Amortization of Tax-Exempt Bond Premium Debt Held to MaturityMandatory Amortization of Tax-Exempt Bond Premium Debt Held to Maturity



There doesn't seem to be a tax policy justification for including wash sale basis adjustments in some cases and ignoring it in others. But the lack of that justification alone is not an excuse to ignore statutory and regulatory guidance requiring wash sale basis adjustments for post-wash-sale replacement securities in the computation of bond premium, acquisition premium, and market discount.⁵⁰ The better answer would be for wash sales to affect the determinations of bond premium, acquisition premium, and market discount rules for a wash-sale-triggering replacement debt instrument, regardless of whether that debt instrument is acquired before or after the date of the wash sale.

V. Conclusion

The federal income tax rules for bond premium have always referred to basis rather than purchase price for purposes of measuring the amount of bond premium, and the same is true for market discount. The bond premium and acquisition premium regulations also refer to a debt instrument's initial tax basis. Taking into account a wash sale basis adjustment for computations of bond premium, acquisition premium, and market discount is consistent with the economic policy for wash

sales, but anomalies can arise because of the asymmetrical consequences of the existing rules. Three possible approaches were described at the outset: (1) Never adjust bond premium, OID, or market discount for wash sales; (2) always adjust bond premium, OID, and market discount for wash sales; and (3) sometimes adjust bond premium, OID, and market discount for wash sales. The analysis set forth above shows that the third approach is existing law. However, I believe the second, symmetrical approach is preferred as tax policy. Perhaps Congress or Treasury should revise these rules to adopt the second approach.

VI. Appendix — OID and Acquisition Premium

A. Acquisition Premium Rule Origin

The OID rules requiring current inclusion by holders of OID bonds were enacted as part of TRA 1969.⁵¹ The rules as enacted included section 1232(a)(3)(B) of the 1954 code, which provided for a “reduction in [the] case of any subsequent holder” in the amount of OID included by that holder in taxable income. This was the original formulation of today’s acquisition premium rule. The rule under section 1232(a)(3)(B) of the 1954 code determined the amount of that acquisition premium (today’s term of art) as an amount:

- equal to the excess of (i) the cost of such bond or other evidence of indebtedness incurred by such holder, over (ii) the issue price of such bond.

B. ‘Purchase’ and Exclusion of Some Exchanges

The original formulation of the acquisition premium rule focused on the cost upon purchase, and section 1232(a)(3)(C) as enacted in 1969 addressed the scope of the meaning of purchase:

- For purposes of subparagraph (B), the term “purchase” means any acquisition of a bond or other evidence of indebtedness, but only if the basis of the bond or other evidence of indebtedness is not determined in whole or in part by reference to the adjusted basis of such bond or other evidence of indebtedness in the hands of the person from whom acquired, or under Section 1014(a) (relating to property acquired from a decedent).

There are several noteworthy aspects of the original formulation of acquisition premium. First, section 1232(a)(3)(B) of the 1954 code uses the term “cost” rather than “basis.” However, the refining definition of section 1232(a)(3)(C) of the 1954 code does refer indirectly to basis by excluding specified acquisitions. Second, the exclusion of some carryover basis acquisitions appears limited to two specific cases: acquisitions in which the basis of the acquired bond is determined in whole or in part from the transferor, and distributions in inheritance in which basis was determined by reference to the inheritance basis step-up rule of section 1014 of the 1954 code. Wash sale transactions involve a basis adjustment determined by reference to a disposed security sold at a loss under section 1091(d). The wash-sale-triggering replacement debt instrument is typically purchased in the open market from a third party in a bona fide arm’s-length transaction. The taxpayer who acquires a wash sale replacement debt instrument does not determine her basis in that debt instrument by reference in whole or in part to the transferor’s basis in the debt instrument. Thus, this original limitation does not appear relevant here.⁵² As discussed below, the exception for debt acquired with a stepped-up basis upon inheritance under section 1014 was legislatively eliminated in 1984. Also, as discussed below, the bond premium rule was amended in 1986 to add its own special exclusion of some exchanges.

C. Revised Acquisition Premium Definition

In 1986 proposed regulations were released addressing important details on the substantial revisions to the OID rules that had been enacted in 1982 and 1984.⁵³ The proposed OID regulations

did not essentially change the prior definition of acquisition premium, which focused on the debt instrument's purchase price.⁵⁴

D. Acquisition Premium on Inheritance

Although the substantive focus of the Deficit Reduction Act of 1984 amendments related to market discount, short-term obligations, and tax-exempt bonds issued with OID, a key aspect of the act for practitioners focused on financial product taxation was the total restructuring and reorganization of the time value of money rules of the 1954 code from prior sections 1232, 1232A, and 1232B to new sections 1271 through 1288.⁵⁵ Buried within this restructuring are noteworthy changes to the definition of acquisition premium for purposes of the OID rules.

The old definition that had been enacted in 1969 and set forth in old section 1232A of the 1954 code was replaced by a slightly different definition set forth in new section 1272(a)(6)(B)(i) of the 1954 code.⁵⁶ The subtle change in law that occurred in connection with this restatement was the deletion of the special purchase exception set forth in prior section 1232(b)(2)(C) of the 1954 code for debt acquired with a stepped-up basis upon inheritance under section 1014.⁵⁷

Because of that change, the stepped-up basis (rather than the decedent's book purchase price) is used by holders who acquire debt as a result of inheritance.⁵⁸

E. Current Definition of Acquisition Premium

Revised proposed OID regulations were issued in 1992.⁵⁹ They replaced the old definition of acquisition premium with the following:

- A debt instrument is purchased at an acquisition premium if it is not purchased at a premium and immediately after its purchase (including a purchase at original issue) its adjusted basis is greater than its adjusted issue price (as defined in section 1.1275-1(b)).

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This new definition explicitly referenced a debt instrument's adjusted basis (immediately after purchase). The final version of the revised proposed OID regulations were adopted in 1994, and they retained the rule that acquisition premium is defined by reference to the debt instrument's adjusted basis immediately after purchase.⁶¹ The 1992 proposed OID regulations also included a rule limiting the amount of acquisition premium in some types of exchanges. Prop. reg. section 1.1272-2(b)(6)(i) provided as follows:

Debt instruments acquired in exchange for other property

- . For purposes of section 1272(a)(7), section 1272(c), and this section, if a debt instrument is acquired in an exchange for other property (other than in a reorganization defined in section 368) and the basis of the debt instrument is determined, in whole or in part, by reference to the basis of the other property, the basis of the debt instrument will not exceed its fair market value immediately after the exchange. For example, if a debt instrument is distributed from a partnership to a partner and the distribution is subject to section 731, the partner's basis in the debt instrument may not exceed its fair market value for purposes of this section.

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The preamble to the 1994 final OID regulations explained the reason behind this rule:

- The final regulations retain the rules in the proposed regulations for debt instruments purchased at a premium. Thus, the holder's basis in a debt instrument that is acquired in exchange for property and that otherwise would take a substituted basis generally will not

exceed the fair market value of the property immediately after the exchange. This rule corresponds to a similar rule in section 171(b)(4) of the Code. The final regulations clarify the application of the rule to a situation in which a debt instrument is received in a distribution from a partnership.

63

The 1994 final OID regulations also clarified the determination of acquisition premium when the debt instrument is acquired by gift:

- For purposes of this section, a donee's adjusted basis in a debt instrument is the donee's basis for determining gain under section 1015(a).

64

Note that this special rule for gifts is generally beneficial to holders and potentially increases the amount of acquisition premium in some cases (as compared with a rule that relies on a lower FMV in determining loss for the disposition of gifted property under some circumstances under section 1015(a)).

FOOTNOTES

¹ Section 1091(d) provides: "If the property consists of stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under this section or corresponding provisions of prior internal revenue laws) of the loss from the sale or other disposition of substantially identical stock or securities, then the basis shall be the basis of the stock or securities so sold or disposed of, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold or otherwise disposed of." *See also* reg. section 1.1091-2 for examples.² *See generally* Stevie D. Conlon, "The Final Phase 3 Cost Basis Regs: Severe Compliance Challenges for Brokers," 118 *J. Tax'n* 311 (2013).

³ Section 1091(d). The net effect is that the basis of the securities acquired will be increased by the unrecognized loss. For example, if a bond with a basis of \$100 is sold for \$90, and an identical bond is acquired for \$100, the unrecognized loss of \$10 is added to the basis of the bond acquired, resulting in a basis of \$110. In the convoluted language of the statute, the basis of the new bond is the basis of the old bond (\$100) increased by the difference between the price at which the property (the new bond) was acquired (\$100) and the price at which the old bond was sold (\$90), *i.e.*, an increase of \$10. *See* reg. section 1.1091-2.

⁴ In general, basis adjustments are not suspended, deferred, or otherwise separately tracked except under specific rules and regulations. Instead, they are generally integrated so that a taxpayer tracks a single, adjusted basis number for each of her respective assets. If basis adjustments for purposes of bond premium and acquisition premium calculations must be separate and distinct from other basis adjustments such as wash sale basis adjustments, a taxpayer (or a broker for cost basis reporting purposes) would need to separately track and maintain the adjustment. A separate data field would be required for transfer reporting purposes under section 6045A. Parallel adjustments would likely be required for corporate-action-related basis adjustments for events such as bankruptcies, workouts, conversions of convertible debt, mergers, and spinoffs.

⁵ Basis for this purpose is generally defined in both section 171(b)(1)(A) and reg. section 1.171-1(e) as "the holder's basis in the bond is the holder's basis for determining loss on the sale or exchange of the bond." The regulations in section 1.171-1(e) acknowledge that because of the special definition of basis for purposes of defining bond premium, "the holder's basis in the bond for

purposes of these sections may differ from the holder's basis for determining gain or loss on the sale or exchange of the bond." Section 171(b)(4) and related reg. section 1.171-1(e)(1)(ii) provide a special rule for bonds received in specified exchanges for other property (other than some exchanges in connection with reorganizations under section 368). As discussed later in this report, this rule does not appear applicable to wash-sales-related basis adjustments because the term "other property" in that context appears to reference property other than bonds or debt instruments. Note that under reg. section 1.1272-2(b)(3), acquisition premium is determined "immediately after its purchase."

⁶ Section 1278(a)(2) defines market discount as "the excess (if any) . . . of the stated redemption price of the bond at maturity, over . . . the basis of such bond immediately after its acquisition by the taxpayer." Once again, note the explicit reference to basis (determined immediately after acquisition) rather than purchase price in that definition. *See also* TAM 200120001 and TAM 9726001 . Various exceptions from the market discount rules, as well as a discussion of special rules, are intentionally omitted.  

⁷ Revenue Act of 1921, section 214(a)(5); section 113(a)(10) of the 1939 code.

⁸ "The property acquired in pursuance of such a wash sale shall for the purpose of determining gain or loss on a subsequent sale *be treated as taking the place of the property sold*" (emphasis added). H. Rep. No. 67-486 (discussion on amendment No. 64 in Revenue Bill of 1921).

⁹ Revenue Act of 1924, section 204(a)(11); section 118(a) of the 1939 code.

¹⁰ Revenue Act of 1932, section 101(c)(8)(D). This provision is now found in section 1223(3).

¹¹ *See* sections 475(d)(1) and 1256(f)(5).

¹² *See* section 1092(b) and reg. section 1.1092(b)-1T(e).

¹³ Hearings before Finance Committee on H.R. 8245, 67th Cong., 1st Sess., at 52. *See* discussion in *Hanlin v. Commissioner*, 38 B.T.A. 811, 821 (1938).

¹⁴ *Hanlin v. Commissioner*, 108 F.2d 429 (3d Cir. 1939).

¹⁵ *Id.* at 430.

¹⁶ We are aware of the uncertainties attendant upon the application of the elastic weasel word "substantially" to other and perhaps economically divergent circumstances. However, that may be, we feel that a conscientious construction of the statute compels the judgment we are about to render. Other courts have hazarded the possibility of future uncertainty in construing the cognate phrase "substantially all" as employed for the purpose of determining whether two corporations are affiliated . . . or whether a transaction is a reorganization. . . . Their labors in the reorganization cases have resulted in a legislative substitution of clear cut percentages in lieu of "substantially," Revenue Act of 1938, section 112. We may say that the statute with which we are now dealing is capable of similar clarification. *Id.* at 432.

See also Commissioner v. Albert Johnston, 107 F.2d 883 (6th Cir. 1939), which involved the sale of securities at a loss and the subsequent arranged purchase of identical securities by the taxpayer's sister during 1932. The Sixth Circuit agreed with the Board of Tax Appeals that the transaction was not a wash sale because the separate acquisition by a different taxpayer (the sister) was bona fide and not imputed to the brother (who had sold the securities at a loss). The related-party rules of section 267, which likely would have disallowed the taxpayer's loss because of the sister's

purchase, were not enacted until 1934 and were therefore not a relevant consideration. It is noteworthy, however, that *Johnston* appears to involve the sale of stocks and securities that included bonds, and nothing in the opinions by the Board of Tax Appeals or the Sixth Circuit suggests that bonds were not covered by the wash sale rule. This decision seems to be the first direct consideration of the applicability of the wash sale rule to debt instruments, although it must be cautioned that this is dicta.

¹⁷ Debt and credit in their various forms have existed since before 600 B.C. *See, e.g.*, David Graeber, *Debt: The First 5000 Years* (2011). Double-entry financial accounting was proposed in the late 1400s by mathematician Luca Pacioli as European merchants began expanding global trade. *See, e.g.*, Andrew Beattie, “Financial History: The Evolution of Accounting,” Investopedia.com (Feb. 26, 2009). As part of financial accounting practice, various rules were developed permitting or requiring depreciation or amortization of various amounts including bond premium. These financial accounting requirements often predated the enactment of the modern federal income tax. *See, e.g.*, the discussion of purchases of promissory notes, bills of exchange, and certificates of deposit at a premium beginning in 1853 in *Humphreyville Copper Co. v. Sterling*, 12 F.Cas. 881 (N.D. Ohio 1859).

¹⁸ Section 125 of the 1939 code, added by section 126(b) of Revenue Act of 1942.

¹⁹ Cited in Rev. Rul. 60-17, 1960-1 C.B. 124.

²⁰ Section 113(a) and (b) of the 1939 code. Note that Congress did not adopt or reference prior financial accounting rules regarding the definition or measurement of bond premium.

²¹ *Commissioner v. Korell*, 339 U.S. 619 (1950).

²² *Id.* at 625.

²³ Section 125(b)(1), amended by section 217(a) of the Revenue Act of 1950.

²⁴ *See Korell*, 339 U.S. at 626, n.9:

- Petitioner cites H.R. Rep. No. 2333, 77th Cong., 2d Sess., 47 (1942), and the statements of John O’Brien, 1 Hearings before Senate Committee on Finance on H.R. 7378, 77th Cong., 2d Sess., 52 (1942), and Randolph Paul, 1 Hearings before House Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d Sess., 90 (1942). None of these can be taken as a clear statement excluding premium reflecting financial inducements other than the interest rate.

²⁵ H. Rep. No. 77-2333 (1942).²⁶ Hearings before the Senate Finance Committee on H.R. 7378, 77th Cong., 2d Sess., vol. 1, at 53 (1942).

²⁷ The market discount rules were enacted under section 41 of the Deficit Reduction Act of 1984.

²⁸ Section 1278(a)(2)(B) of the 1954 code provided the following special definition of market discount for debt instruments issued with OID: “in the case of any bond having original issue discount, for purposes of subparagraph (A), the stated redemption price of such bond at maturity shall be treated as equal to its revised issue price.”

²⁹ “If the market discount is less than $-1/4$ of 1 percent of the stated redemption price of the bond at maturity multiplied by the number of complete years to maturity (after the taxpayer acquired the bond), then the market discount shall be considered to be zero.” Section 1278(a)(2)(C) of the 1954 code.

³⁰ See, e.g., the definition of market discount in H. Rep. No. 98-432 (1984).

³¹ Section 1803(a)(11)(A) of TRA 1986.

³² The addition of section 171(b)(4), modifying the definition of bond premium (effective for exchanges after May 6, 1986), was set forth in section 1803(a)(12)(A) of TRA 1986, and the addition of section 1278(a)(1)(C)(iii) and (iv) concerning the definition of market discount was set forth in section 1803(a)(6).

³³ See, e.g., the TRA 1986 blue book discussion of the market discount definition change:

- Under the Act, two statutory exceptions are provided. The first exception relates to bonds that are part of an issue that is publicly offered. Because the Act provides that the issue price of publicly offered bonds (other than bonds issued for property) is the price at which a substantial amount of the bonds are sold, the OID provisions are inapplicable to a portion of the OID with respect to bonds acquired on original issue by large investors at “wholesale” prices (at deeper discounts than those available to “retail” customers). Under the Act, market discount is created on original issuance of a bond if the holder has a cost basis determined under section 1012, and such basis is less than the issue price of the bond. The difference between the holder’s issue price and basis is treated as market discount.

The second statutory exception applies to a bond that is issued in exchange for a market discount bond pursuant to a plan of reorganization. This exception is intended to prevent the holder of a market discount bond from eliminating the taint of unaccrued market discount by swapping the bond for a new bond (e.g., in a recapitalization). Solely for purposes of the interest characterization rule, however, this exception is inapplicable to a bond issued in exchange for a pre-enactment market discount bond where term and interest rate of the new bond is identical to that of the old bond.

Joint Committee on Taxation, “Explanation of Technical Corrections to the Tax Reform Act of 1984 and other Recent Tax Legislation” (May 13, 1987). See also David C. Garlock, *Federal Income Taxation of Debt Instruments*, section 1208: “Although the legislative history does not explain the purpose for this rule, it apparently was designed to prevent taxpayers from converting capital losses on depreciated property into amortizable premium through a tax-free exchange of that asset for property including (or consisting solely of) a bond.”

³⁴ The concept of an exchange, like a sale, in the law generally envisions two different entities (two persons, a person and her corporation, a person and herself as trustee, etc.) exchanging property or engaging in a bargain and sale at arm’s length. Intrataxpayer transactions are generally ignored for tax purposes: “Generally speaking, the language in the Revenue Act [of 1934], just as in any statute, is to be given its ordinary meaning, and the words ‘sale’ and ‘exchange’ are not to be read any differently.” *Helvering v. Flaccus Oak Leather Co.*, 313 U.S. 247, 249 (1941). In a wash sale, there are two sales in the marketplace between the buyer and seller, not an exchange of one security for a substantially identical security, any more than selling one’s old car and buying a new one is an exchange of cars in a legal sense.

³⁵ Garlock, *supra* note 33, at section 1208.

³⁶ Section 43(a)(1) of the Deficit Reduction Act of 1984 added definitions for substituted basis property, transferred basis property, and exchanged basis property — section 7701(a)(42), (43), and (45), respectively. Substituted basis property is defined as both transferred basis and exchanged basis property. Transferred basis property refers to basis “determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.” Exchanged basis

property refers to basis “determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.” Despite a seemingly broad definition, exchanged basis does not seem to include the fundamentally different concept of sale, which is an arm’s-length market transaction. The JCT explanation of the 1984 act, in discussing the carryover of market discount on exchanged basis property, states: “The amount of accrued market discount with respect to ‘exchanged basis property’ (property received by a taxpayer in a nonrecognition transaction the basis of which is determined in whole or in part by reference to the basis of property that was transferred by the taxpayer in the transaction) includes any accrued market discount to the extent such amount was not previously treated as interest income under the provisions of the Act. For example, on the disposition of stock received upon the conversion of a convertible bond or in a recapitalization in which a bond was exchanged for stock, gain is treated as interest income to the extent of the amount of accrued market discount as of the date of conversion.” JCT, “General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984” (Dec. 31, 1984). *See generally Basis Variations*, section I(A)(2), BNA Tax Management Portfolio 560-3d.

³⁷ T.D. 8746 .



³⁸ *Id.* The preamble to the final bond premium regulation provides the following explanation concerning the definition of bond premium:

- Under the proposed regulations, bond premium is defined as the excess of a holder’s basis in a bond over the sum of the remaining amounts payable on the bond other than payments of qualified stated interest. The holder generally determines the amount of bond premium as of the date the holder acquires the bond.

The proposed regulations provide special rules that limit a holder’s basis solely for purposes of determining bond premium. For example, if a bond is convertible into stock of the issuer at the holder’s option, for purposes of determining bond premium, the holder must reduce its basis in the bond by the value of the conversion option. This reduction prevents the holder from inappropriately amortizing the cost of the embedded conversion option.

The final regulations adopt the rules of the proposed regulations for determining the amount of bond premium, if any, on a bond. However, in response to comments, they clarify the determination of basis in the case of a convertible bond acquired in a transferred basis transaction.³⁹ Reg. section 1.171-1(d)(1).

⁴⁰ Reg. section 1.171-1(e)(1)(ii). There is a special rule in reg. section 1.171-1(e)(1)(iii)(B) for exchanges involving convertible bonds.

⁴¹ Reg. section 1.171-1(f), Example 1.

⁴² T.D. 8746. The preamble states:

- Sections 1.171-1 through 1.171-4 of the Income Tax Regulations were promulgated in 1957 and last amended in 1968. In the Tax Reform Act of 1986, section 171(b) was amended to require that bond premium be amortized by reference to a constant yield. In the Technical and Miscellaneous Revenue Act of 1988, section 171(e) was amended to require that amortizable bond premium be treated as an offset to interest income.

On June 27, 1996, the IRS published a notice of proposed rulemaking in the Federal Register (61 FR 33396) relating to the federal income tax treatment of bond premium and bond issuance premium. A public hearing was not held because no one requested to speak at the hearing that had been scheduled for October 23, 1996. The IRS did receive a few comments on the proposed regulations.

The proposed regulations, with certain changes to respond to the comments, are adopted as final regulations.

⁴³ Of course, the rules must be followed regardless of whether they are sensible.⁴⁴ Section 1091(a).

⁴⁵ See *supra* note 8.

⁴⁶ The identical bond is a post-wash-sale replacement security.

⁴⁷ This is consistent with the legislative substitution theory of the rule as discussed in note 8, *supra*. Another potential concern with existing law is that the addition of wash sale basis adjustments can not only increase the amount of acquisition premium or reduce the amount of market discount, but also transform a bond that is putatively acquired at a discount into a bond that is treated as acquired with bond premium (crossing over). A detailed discussion of crossing over is intentionally omitted. However, existing law supports this result.

⁴⁸ See reg. section 1.171-3(c)(4)(ii)(A) and compare the rule for taxable and tax-exempt bonds. Similarly, failing to take into account a wash sale basis adjustment on a tax-exempt bond issued with OID could result in a basis in excess of the bond's stated redemption price at maturity if the amount of acquisition premium does not reflect the basis adjustment. Congressional concern regarding the taking of losses of tax-exempt bonds was also addressed in the enactment of section 1288 of the 1954 code as part of the Deficit Reduction Act of 1984. In discussing the reason for the change from prior law, the relevant House report provides:

- Recently, there has been a significant increase in the issuance of zero coupon tax-exempt bonds. The Committee is concerned that taxpayers may acquire these obligations to generate tax losses to shelter income. Although it appears to be the position of the Internal Revenue Service that no loss is allowable based on the linear accrual of tax-exempt OID, some taxpayers have claimed that such losses are allowable. The committee believes that OID on zero coupon municipal bonds should be accrued in the same manner as that provided for OID on obligations issued by corporations and other juridical entities. The committee intends no inference regarding the proper treatment of obligations acquired before the effective date of the bill. Discussion of OID on tax-exempt bonds, new Sec. 1288 in House Ways and Means Committee report on Tax Reform Bill of 1984, House Rept. 98-432 (March 5, 1984).

⁴⁹ The same is true for acquisition premium based on the definition in reg. section 1.1272-2.⁵⁰ It could be argued that taking into account the wash sale rules in determining the amount of bond premium, acquisition premium, and market discount is unreasonable. However, federal income tax law generally is based on the letter of the law and regulations. This principle is so firm that even statements in IRS publications are not law and have no legal authority. The intent of tax law provisions and assessments of their reasonableness are relevant only in limited circumstances. In fact, arguments of reasonableness or unreasonableness of law or regulation generally carry little weight. See, e.g., the discussion in *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837, 842-843 (1984):

- When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on

a permissible construction of the statute.

It could also be argued that the computation of yield, as well as the determination of the amount of bond premium, OID, and market discount should follow financial market and financial accounting methods rather than a different set of tax rules. That argument should be categorically rejected. First, on examination of the tax rules for bond premium, OID, or market discount, one quickly discovers that these guidelines are complex, clearly spelled out statutory rules and regulations. On closer inspection, these tax rules differ in many key details from related financial market and accounting methods for bond premium, OID, and market discount (for example, financial analysts do not generally distinguish between OID and market discount from the perspective of investors in debt instruments). Second, generally, federal income tax rules are different because the goals and objectives of tax accounting methods are fundamentally different from the goals and objectives of financial market practices and financial accounting principles. For an unequivocal statement by the Supreme Court on this, look no further than *Thor Power Tool v. Commissioner*, 439 U.S. 522 (1979). *Thor Power Tool* is the landmark case that rejected the use of financial accounting inventory write-downs for tax purposes and specifically rejected the general acceptability of financial accounting principles for federal income tax purposes.⁵¹ As part of section 413 of TRA 1969.

⁵² There is a detailed discussion in H. Rep. No. 91-413, pt. 2 (1969), that also includes discussion of the special definition of purchase with reference to basis and the special rule if basis is determined by reference to the person from whom acquired. However, it does not provide any additional insight.

⁵³ LR-189-84 (regulations proposed Apr. 8, 1986).

⁵⁴ *Id.* As set forth in reg. section 1272-1(g)(2)(ii):

- The ratable amount of acquisition premium is equal to —
 - A. The excess (if any) of the purchase price over the revised issue price on the date of purchase, divided by

B. The number of days beginning on the date of purchase and ending on the day before the stated maturity date.

⁵⁵ See introductory language of section 41(a) of the Deficit Reduction Act of 1984.⁵⁶ And section 1272(b)(4)(B)(i) of the 1954 code for corporate debt instruments issued before July 2, 1982. The 1982 amendments to the OID rules that resulted in the demarcation between pre- and post-July 2, 1982, debt, although generally significant, are irrelevant here.

⁵⁷ The JCT explanation stated that under prior law, the definition of purchase excluded “the acquisition of a bond the basis of which is determined by reference to the basis of the bond in the hands of the transferor or under section 1014(a) (relating to property acquired from a decedent).” The reason for the 1984 change was the 1982 revision of the OID rules, which “presented a number of technical issues that required legislative solutions.” The revision removed the exclusion so that “the acquisition of a bond from a decedent is treated as a purchase for purposes of the OID provisions, including the rules applicable to stripped bonds and stripped coupons.” JCT, “General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984” (Dec. 31, 1984).

⁵⁸ See Garlock, *supra* note 33, at section 511.01: “Thus, the acquisition premium rules apply to tax-free exchanges of debt instruments, acquisitions by gift or bequest, distributions from partnerships and corporations, etc.”

⁵⁹ FI-189-84, 57 F.R. 60750 (Dec. 22, 1992).



⁶⁰ 1992 prop. reg. section 1.1272-2(b)(3).

⁶¹ T.D. 8517 at reg. section 1.1272-2(b)(3):

- A debt instrument is purchased at an acquisition premium if its adjusted basis, immediately after its purchase (including a purchase at original issue), is —
 - (i) Less than or equal to the sum of all amounts payable on the instrument after the purchase date other than payments of qualified stated interest (as defined in section 1.1273-1(c)); and
 - (ii) Greater than the instrument's adjusted issue price (as defined in section 1.1275-1(b)).

⁶² The 1994 final OID regulations slightly modified this exception:

- (i) Debt instruments acquired in exchange for other property. —
- For purposes of section 1272(a)(7), section 1272(c)(1), and this section, if a debt instrument is acquired in an exchange for other property (other than in a reorganization defined in section 368) and the basis of the debt instrument is determined, in whole or in part, by reference to the basis of the other property, the basis of the debt instrument may not exceed its fair market value immediately after the exchange. For example, if a debt instrument is distributed by a partnership to a partner in a liquidating distribution and the partner's basis in the debt instrument would otherwise be determined under section 732, the partner's basis in the debt instrument may not exceed its fair market value for purposes of this section.

Reg. section 1.1272-2(b)(6)(i).⁶³ Preamble, T.D. 8517.

⁶⁴ Reg. section 1.1272-2(b)(6)(ii).

END OF FOOTNOTES