Bond Case Briefs

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New Reporting Rules Subject OID on Tax-Exempt Bonds to Information Reporting.

Generally, a person that pays interest on a debt to another person must report the amount of interest, usually on IRS Form 1099-INT. In the past, payments of tax-exempt interest did not have to be reported in this way; however, beginning in 2006, the statutory exclusion from information reporting for interest on tax-exempt obligations was eliminated. Since that time, interest on tax-exempt obligations has been reported in the same manner as taxable interest. Mercifully, for information reporting purposes, the amount of tax-exempt interest that must be reported has been limited to qualified stated interest (a fancy term which typically refers to the coupon on a debt instrument). Bond trustees and other payors of tax-exempt interest found refuge in a line item in the instructions to the Form 1099-INT that says "[n]o information reporting for tax-exempt OID under section 6049 [of the Internal Revenue Code] will be required until such time as the IRS and Treasury provide future guidance."

If you read the title of this post and your internet server has frozen so that you are unable to navigate away from this page, you have probably guessed that this "future guidance" has now arrived. The Treasury Department recently finalized Treas. Reg. § 1.6049-10 in TD 9750 (the "Final Regulations"). The Final Regulations, among other things, will now require bond trustees and other payors to report original issue discount on tax-exempt obligations.[1] This post will discuss the motivations behind the change as well as the ramifications that the Final Regulations will likely have on the tax-exempt bond community.

Why Would Congress Require the Reporting of Tax-Exempt Interest to the IRS?

You likely know that when you receive a tax information return (e.g., a mortgage statement, Form 1099-INT, etc.) the person that sent it to you also sends the exact same information to the IRS a few weeks later.[2] This "dual reporting" enables the IRS to monitor the taxpayer-recipient to ensure that the taxpayer properly reports on its income tax return (Forms 1040, 1120, 1065 etc.) all of the income that was listed on the information return. For obvious reasons, the IRS has been less concerned with ensuring that tax-exempt interest (including OID) is properly reported on an information return, because tax avoidance is less of a concern when talking about interest that is tax-exempt.

Congress has imposed information reporting requirements on tax-exempt interest (including OID) for two reasons. First, in 2008, Congress enacted the Energy Improvement and Extension Act of 2008 (the "2008 Act"). Tucked away in Section 403 of the 2008 Act is a requirement that brokers use an information return to report "gross proceeds" from the sale of a "covered security."[3] Now, as you might expect when reading a blog dedicated to all things 103, tax-exempt bonds are considered "covered securities" provided they are acquired by the bondholder on or after January 1, 2014.[4] To comply adequately with the 2008 Act, brokers need to report the "adjusted basis" of tax-exempt obligations (to ensure that taxpayers are recognizing the correct amount of gain or loss upon the disposition of tax-exempt obligations[5]), which is calculated by taking into consideration original issue discount and original issue premium.[6]

Second, the information is required to enable the IRS to verify that bondholders are reporting the correct amount of tax-exempt interest (including OID) for alternative minimum tax and other purposes. Interest (including OID) on certain tax-exempt obligations, such as exempt facility bonds, is directly subject to the alternative minimum tax. In addition, even if not directly subject to the alternative minimum tax (e.g., interest on governmental use obligations, qualified 501(c)(3) bonds, etc.), tax-exempt interest (including OID) is frequently included in adjusted current earnings for corporations, which indirectly subjects the interest (including OID) to the alternative minimum tax.

Final Regulations

Pursuant to the Final Regulations, for "tax-exempt obligations" that are acquired on or after January 1, 2017,[7] a "payor" is required to report the daily portions of accrued OID to the holder as if the payor actually paid those daily portions to the holder in the calendar year.[8] "Tax-exempt obligations" include any obligations the interest on which is not includible in gross income under Section 103 of the Code or under any other provision of the law. OID is determined without regard to the de minimis rule in Section 1273(a)(3) of the Code.

"Payor" is broadly defined in the Final Regulations to include (i) every person who makes a payment of the type and of the amount subject to reporting to any other person during a calendar year, or (ii) every person who collects on behalf of another person payments subject to reporting or who otherwise acts as a "middleman" with respect to such payment.[9] A "middleman" includes any person, including a financial institution and a broker, who makes payment of interest for, or collects interest on behalf of, another person, or otherwise acts in a capacity as intermediary between a payor and a payee.[10] It is unclear to what extent, if any, that municipal issuers are considered payors; however, trustees and broker-dealers are almost certainly included.

Conclusion

Prior to 2006, interest as well as OID and original issue premium were exempt from all information reporting requirements. However, the desire to narrow the "Tax Gap" has led to the recent expansion of the information reporting requirements.[11] Although the Final Regulations do not expand on the definition of "payor" beyond the scope of persons previously obligated to report tax-exempt interest, the Final Regulations certainly expand the breadth of reportable payments subject to information reporting. In addition, this expansion signals a fundamental shift in certain payors' annual reporting obligations to include amounts not actually paid during the calendar year.

Footnotes

[1] Reporting bond premium (Box 13 of the Form 1099-INT) was introduced a few years ago in 2014. In addition, "Specified Private Activity Bond Interest" is reported in Box 9 of the Form 1099-INT so payments on a single tax-exempt obligation are often reported in multiple different boxes on the Form 1099-INT.

[2] The obligation to report various types of "reportable payments" could fall on any number of individuals or entities in addition to financial institutions.

[3] The form to be used is Form 1099-B, which was recently voted the "worst tax form" according to an informal survey of tax preparers.

[4] The January 1, 2014 implementation date was in response to practitioners concerns that the information needed to populate an information return with the details of tax-exempt obligations was not available on the Electronic Municipal Market Access if the obligation was outstanding as of

November 1, 2012.

[5] Disclosures frequently say that original issue discount and original issue premium will have no impact on the bondholder if the bondholder holds the instrument to maturity. However, if the bondholder disposes of the bond prior to its maturity, there may be tax consequences that arise from the fact that the bond had original issue premium or discount.

[6] See Treas. Reg. 1.6045-1 (Definition of “adjusted basis” for a debt instrument).

[7] Although OID must be reported to the bondholder for obligations acquired on or after January 1, 2017, brokers have been required to monitor and compute OID on tax-exempt obligations since 2013 when the final basis reporting regulations were promulgated.

[8] See Treas. Reg. 1.6049-10(a) and Treas. Reg. 1.1272-1(2)(b) (for rules governing the accrual of OID and the determination of daily portions of OID).

[9] See Treas. Reg. 1.6049-4(a)(2).

[10] See Treas. Reg. 1.6049-4(f)(4).

[11] The most recent estimated tax gap for calendar years 2008-2010 is $406 billion each year with a net compliance rate of approximately 83.7 percent.

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The Public Finance Tax Blog

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