Bonds and the original issue discount: Easy does it

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With the investment landscape changing investors have shown interest in more secure and conservative investment vehicles. Many clients have expressed an interest in bonds. However, the complexity of the varying bond vehicles and the income tax implications is often something that clients fail to understand.

When a bond is issued at substantially less than par value ("face value"), the difference between the face value and the purchase price is known as Original Issue Discount ("OID"). The OID on a bond will vary depending on whether the bond pays any interest to the bond holder or none at all. A bond that pays no interest is often referred to as a zero coupon bond. To illustrate OID, if a 10 year zero coupon bond is purchased for $100,000, but the face value of the bond is $250,000, the OID is $150,000. But whether this zero coupon bond is a good investment or whether the OID offered on a particular bond is a good investment can be a complex question.

In the illustration above, the bond is worth $150,000 more than the purchase price. A $150,000 gain over 10 years from a bond that cost $100,000 may seem like a prudent investment, but there is a reason why this payment is so high. The OID is compensating the holder of the bond, not only for the $100,000 cost, but also for foregoing the interest that accrued on the bond. As the interest is accrued (but not distributed), the holder of the bond must pay the income tax on the interest even though he or she has not actually received the interest. This is contra to other investments, where an individual purchases the investment and then receives interest payments over the term of the investment, and is logically responsible for the

income tax on that interest.

To better appreciate how an OID bond works, there are three main aspects of OID that should be understood:

(1) The bond holder reports the OID and any interest payments as interest income annually;

(2) The amount that the bond holder will have to report every year as ordinary income will increase each year because the interest compounds; and

(3) The basis in the investment increases on a yearly basis as OID is accrued, which is important because capital gain is determined by subtracting the adjusted basis from the sale value.

Zero-Coupon Bond Illustration

Assume that Mr. X has the opportunity to buy a zero coupon bond for $100,000 that will mature in 10 years with a face value of $250,000. Over that time, the bond yields an interest rate of approximately 10 percent per year. In year one, Mr. X will earn $10,000 in interest, which is reported in year one, but not distributed to Mr. X. Mr. X will be responsible for any income tax due on the interest in year one. The $10,000 OID is then added to the basis in the bond, so that the adjusted basis of the bond is $110,000.

In year two, Mr. X will again earn 10 percent interest. The interest in year two will increase to $11,000 because the $10,000 of interest was added to the original bond investment of $100,000. In year two Mr. X will have $11,000 in OID and will be responsible for income tax on this interest. The new OID will be added to the basis of the bond, so that the adjusted basis of the bond is $121,000.

This process will repeat for the 10 term and the bond will accumulate approximately

$150,000 of OID. Mr. X will be responsible for the income tax, on an annual basis, for the OID during the ten year term. This OID or interest is then added to the cost basis of the bond making the adjusted basis of the bond $250,000.

2% Interest Bond Illustration

Assume the same facts above, except that the bond pays out 2 percent in interest (instead of 0 percent) but earns 10 percent interest.

If Mr. X purchases the bond described above, there will be 10 percent interest in year one, but 2 percent interest will be paid to Mr. X in year one. Also, in year one there will now be $8,000 in OID (the OID on the bond is 8 percent). The $8,000 OID is then added to the adjusted basis of the bond making the adjusted basis $108,000. But note that Mr. X will still be responsible for income tax on the full $10,000 in year one, not just the $2,000 that he actually received. In year two and every year thereafter, the OID would be 8 percent of the adjusted basis and the interest paid to Mr. X would be 2 percent of the adjusted basis. So every year, Mr. X will receive 2 percent of the interest, but will be responsible for income tax on all 10 percent. It may appear that receiving 2 percent is better than receiving 0 percent, but there is an investment risk in receiving the 2 percent interest. Will the 2 percent be reinvested at a rate higher than that offered by the bond?

Once it is clear how an OID bond functions, it is extremely important to thoroughly consider the consequences of purchasing an OID bond before doing so. Three key issues that must always be considered before deciding to purchase an OID bond are:

(1) Is the interest rate better than the interest

rate offered by other comparable investments?

(2) Can you afford to wait until the bond's maturity date to receive the interest accrued on the bond?

(3) Can you afford to pay the tax on the OID every year?

Purchasing an OID bond can be a wise investment if the bond pays a generous rate of return and the investor is geared for a long term investment in which he or she will wait to receive the interest. However, if income tax liability for the investment income creates even more financial difficulty in the short term, the OID bond will not be an appropriate vehicle for that investor. ∎