

IRC Section 1278(b)

Election to Include Accrued Market Discount in Income Currently

Overview

IRC §1276(a) generally provides that gain on the disposition of any market discount bond is treated as ordinary interest income. In addition, §1277 limits the amount of interest expense which may be deducted with respect to a market discount bond to the excess of such net direct interest expense over the portion of the market discount allocable to the days during the taxable year on which such bond was held by the taxpayer. However, if a taxpayer makes a §1278(b) election, market discount will be included in income currently in the tax years to which it is attributable, and §§1276 and 1277 will not apply. Therefore, the effect of this election is to accelerate the recognition of gross income and to avoid the rules deferring the deduction of interest expense.

If the §1278(b) election is made, the taxpayer may compute the includible amount of market discount under the §1276 ratable accrual method or make the §1276(b)(2) election to use the constant interest rate method provided in §1272. The amount included in gross income by making this election will be treated as interest income for most sections of the Internal Revenue Code.

Market discount is generally defined as the amount by which the stated redemption price of a bond at maturity exceeds the acquisition cost of a market discount bond. For purposes of §1278, market discount bond does not include obligations that mature within one year of issuance, installment obligations, U.S. savings bonds, tax-exempt bonds purchased before May 1, 1993, and bonds acquired at their original issue.

If a taxpayer makes a §1278(b) election, it applies to all market discount bonds, regardless of their issue date, acquired in the year of election and to all such bonds in all future tax years. The basis on the bond is increased by the amount included in gross income pursuant to the §1278(b)(1) election. Once made, the election may only be revoked with the consent of the Commissioner. No election can be made if a previous §1278(b) election had a revocation date within five calendar years of the election date. Rev. Proc. 92-67 provides procedures to obtain automatic consent for the change in accounting method.

When to File

The election is made by attaching a statement to the taxpayer's income tax return for the first taxable year for which the election is to be effective. The statement must describe the method used to determine the market discount attributable to the tax year covered by the tax return. The election must be made no later than the due date, including extensions, of the taxpayer's return for such year.

Where to File

The election statement is attached to the taxpayer's timely filed income tax return, which is mailed to the designated Internal Revenue Service Center.

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1. Code Section: 1276, 1277, 1278
2. Topic: Accounting Periods and Methods; Deduction Items; Gain/Loss; Gross Income
3. Return Type: 1040, 1065, 1120,

Authorities

IRC §1278(b); Rev. Proc. 92-67