

L. Amortization of Bond Premiums (G.S. 105-130.5) (17 NCAC 05C.1400)

1. Preliminary Statement

If a corporation purchases a bond at more than its face value, the amount of premium paid may be amortized over the life of the bond. However, the allowance of a deduction against net income for amortization of the premium paid depends upon the type of bond purchased by the corporation.

Amortization of premiums on *tax-exempt* bonds by a corporation is mandatory with no deduction allowed in computing State net income.

A corporation may at its option amortize the amount of premiums paid on *taxable* bonds over the life of the bonds. If the premium is not amortized by the corporation, it will constitute part of the basis of the bond in determining gain or loss at maturity or sale.

For State income tax purposes, obligations of the United States or its possessions and obligations of the State of North Carolina or any of its subdivisions are tax-exempt. Interest income received by a corporation on such obligations is not taxable; however, a corporation must include in its computation of State net income any gain or loss realized on the disposal of such obligations.

Premiums paid on all bonds acquired prior to January 1, 1963 cannot be amortized but constitute a part of the cost basis of the bonds in determining gain or loss when the bonds are sold.

2. Tax-Exempt Bonds

The amount of premium paid upon the purchase of a tax-exempt bond is amortized over the life of the bond. Amortization for the taxable year is accomplished by reducing the original cost of the bond by a portion of the premium paid, with no deduction against net income for the year. Therefore, when the bond is sold or otherwise disposed of, the basis for determining gain or loss will always be original cost less the amount of premium amortized for book purposes through the year of disposal.

Example: A corporation pays \$5,100 for a 5-year tax-exempt interest-bearing bond having a par value of \$5,000. The premium of \$100 paid upon the purchase of the bond must be amortized over the life of the bond and cannot be used as a deduction in determining net income. The bond is sold after two years for \$5,100. Although interest earned on the bond is not taxable, the corporation is required to report the sale as follows:

Sales price	\$5,100
Basis of bond sold:	
Cost	\$5,100
Less: Premium amortized	<u>40</u>
	<u>\$5,060</u>
Gain	\$ 40

3. Taxable Bonds

A portion of the premium paid upon the purchase of a taxable bond may be deducted in the taxable year only if an adjustment is made to the basis of the bond. If a taxpayer

elects to amortize the premium, the basis for determining gain or loss will always be original cost less the amount of premium amortized and deducted in its tax returns through the year of disposal. Otherwise, the basis of a taxable bond for determining gain or loss will always be the entire amount paid for the bond.

Examples:

- a. A corporation pays \$12,500 for a taxable interest-bearing bond having a par value of \$12,000. The bond matures in ten years. Since the interest from the bond represents taxable income to the corporation, it elects to amortize the premium paid over the life of the bond. One-tenth of the premium, or \$50, is allowable as an annual deduction in determining net income. At the end of five years the corporation sells the bond for \$12,375. The corporation is required to report the sale as follows:

Sales price	\$12,375
Basis of bond sold:	
Cost	\$12,500
Less: Premium amortized	<u> 250</u>
	<u>\$12,250</u>
Gain	\$ 125

- b. In the previous example, if the corporation had elected not to amortize the premium, it would be required to report the sale of bond as follows:

Sales price	\$12,375
Basis of bond sold:	
Cost	<u>\$12,500</u>
Loss	(\$ 125)

4. Definition of Bond

The term “bond” means any bond, debenture, note, or certificate or other evidence of indebtedness issued by any corporation and bearing interest and includes any like obligation issued by any government or political subdivision thereof.