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TAXING SUBJECT

# TIPS and Taxes

## Uncle Sam's take on "unreceived" interest

**By JOSEPH F. GELBAND**

**ONE OF THE MOST DISTURBING** (and confusing) moments you may experience as an investor at tax time is coming across a 1099-INT notice from your broker that indicates an original-issue discount, or "OID" -- something you never received but are nonetheless supposed to report as interest income.

This will come up if, for example, you hold TIPS (Treasury Inflation-Protected Securities) bonds, in your account. Your statement reflects the interest you actually received from those bonds, and, in addition, an amount as OID.

The small print in back of the statement, which informs you that OID "is the excess of an obligation's stated redemption price at maturity over its issue price," is not much help. After all, especially if you bought the TIPS at a Treasury auction, the discount (perhaps a small fraction of a point below the bond's nominal $1,000 issue price) is hardly sufficient to explain the unreceived interest you are expected to report. So what's going on?

Remember why you bought the TIPS in the first place. These bonds have been issued by the Treasury since 1997 to provide investors with some protection against inflation. They are currently issued semiannually with a 10-year maturity and a specified interest rate; those issued last July carry a 3% fixed rate, payable in July and January.

But on what is the fixed rate figured? The principal of the bonds moves up in value in line with inflation every six months, and the fixed interest rate (3% in our example) is calculated on their increased value, so that with each rise in the general price level, higher cash payments are thrown off as interest. What you may have forgotten is that the redemption value of your TIPS is not the usual $1,000 per bond, but its $1,000 original "par" value augmented by the inflation over its 10-year life.

Thus the OID, the phantom "interest" on which you are taxed, represents the annual increase in the value of your investment in the TIPS. Be sure to increase your tax basis for these bonds every year by the OID, so that you will incur no tax on the proceeds of their eventual redemption, or incur a lower tax if you sell them before maturity. And, don't forget to adjust your state (and local) tax returns for this OID -- as income from a U.S. obligation, it is not subject to state or local income tax.

It is frequently suggested that while bonds that generate OID are suitable for your IRA or other tax-exempt retirement plans, the need to dig into your pocket each year for the tax on income you don't get makes them inappropriate for unsheltered portfolios.

Sure, as that argument goes, you get an increase in your tax basis, but that comes at a tax cost at the higher

rates in your top ordinary-income brackets; and you give up the time value of the tax you pay now for a future benefit. Perhaps a better view is that your tax on this unpaid income is an investment comparable in effect to any investment you make -- you might, for example, take $1,000 of salary, pay $380 in income tax and invest the remaining $620; you haven't enjoyed the immediate use of any part of that $1,000, but you have added $620 of tax basis to your portfolio. Or you could compare the taxation of OID to the usual dividend-reinvestment program, in which you are taxed on the withheld and automatically reinvested dividends.

You will also have OID to report in connection with your certificates of deposit if they are for a term longer than a year and don't pay the stated interest until they are redeemed. The principle is the same as with TIPS, except that since the redemption value of the CD is fixed at the outset, the OID can be calculated in advance.

Before your eyes glaze over, note that OID on tax-exempt, or municipal, bonds -- consistent with the tax code's rule that OID is essentially interest income -- is exempt from federal income tax. Capital gains on munis, however, do not enjoy such exemption. So be careful to increase your tax basis on these bonds each year by any indicated OID.

Here's a checklist of some other items that may help with your tax return:

• Income from the Tennessee Valley Authority, whether called dividends or interest, is exempt from state and local income taxes, as is the interest paid by the Federal Home Loan Bank. Not exempt are interest payments from the Federal Home Loan Mortgage Corp., or Freddie Mac; the Government National Mortgage Association, and Fannie Mae.

• Review your brokerage statements, and be especially wary if you've changed brokers. Often lost in the shuffle, for example, are deductions for accrued interest you paid on any bond bought in the old account between interest dates (deductible against your first payment from the bond), and any wash sale in the old account resulting from a purchase (within 30 days of the loss sale in the old account) in the new account, as well as your increased basis for the new security.

• Finally, the Medicare tax is considered a medical-insurance expense, and counts towards the 7.5% threshold for the medical-expense deduction on Schedule A. If you were employed last year, the Medicare tax was taken out of your entire salary at the rate of 1.45%; and if you were self-employed, your Medicare tax is computed on Schedule SE as part of the self-employment tax.

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