

## Tax Treatment of TIPS

Taxable investors must determine the benefits of investing in any asset class or strategy on an after-tax basis. With fixed income securities, much of a bond's total return derives from income which is subject to the individual's tax bracket, and thus does not benefit from favorable capital gains treatment unless interest rates go down and a bond's price appreciates. This is the reason that an individual's strategic allocation to bonds is often placed in a tax-deferred retirement account or IRA.

Many investors have realized that the Inflation-Indexed asset class may be quite useful to them, as they will not only receive a real return, but in addition an inflation-protected real return as they are paid a fixed coupon plus the rate of inflation.

Like all U.S. Treasury securities, TIPS are subject to federal taxation, but are not subject to state and local taxes

In most cases the tax treatment of TIPS is subject to the coupon bond method. The exceptions are original issue discounts and strips, which are subject to the discount method.

### Coupon bond method

- **Coupon Income.** The coupon bond method is a simplified method of accounting for qualified stated interest and inflation adjustments (OID) on certain indexed debt instruments. Under the coupon bond method, qualified stated interest is taken into account under the taxpayer's regular method of accounting.
- **Inflation adjustment to Principal.** Any increase in the inflation-adjusted principal amount is also treated as income for the period in which the increase occurs. Income is measured by subtracting the inflation-adjusted principal amount of the security at the beginning of the year/period from the inflation-adjusted principal amount of the security at the end of the year/period.
- **Deflation adjustment to Principal.** The deflationary adjustment reduces the interest otherwise includible in income. If the amount of the deflationary adjustment exceeds the interest otherwise includible in income for the taxable year, the holder of the TIP Security treats the excess as an ordinary loss in the taxable year. If the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year, the excess is carried forward to offset interest income on the debt instrument in subsequent taxable years.
- **Minimum guarantee payment.** Certain inflation-indexed debt instruments may provide for an additional payment at maturity if the total amount of inflation-adjusted principal

paid on the debt instrument is less than the instrument's stated principal amount. If this is the case, a minimum guarantee payment is ignored until the payment is made. If a minimum guarantee payment is made, the payment is treated as interest on the date it is paid.

### **Discount bond method**

- Inflation-indexed debt instruments that don't qualify for the coupon bond method (for example, issued at a discount), the instrument is subject to the discount bond method. There is a five-step process used to determine inflation adjustments (OID). The first step is to determine the debt instrument's yield to maturity as if there were no inflation or deflation. Next, the taxpayer must determine the accrual period. The third step is to determine the percentage change in the reference index during the accrual period. Fourth, the taxpayer must determine the OID allocable to each accrual period by using a formula that takes into account both the yield of the instrument and the percentage change in the value of the reference index. Finally, the taxpayer must determine the daily portions of OID.
- TIPS are eligible for the Dept. of the Treasury's STRIPS program. Under this program, the interest and principal components of a TIP Security may be transferred as separate instruments. A holder of these securities must use the discount bond method.