

Amortization and accretion

Amortization, when used to calculate the yield at any given time of a fixed-income investment bought at a premium, is the writing off of the investment's premium over its projected life until maturity.

Accretion is the accumulation of paper value on a discounted fixed-income investment until it reaches maturity.

When investors buy fixed-income securities they often purchase them at prices above or below face (or par) value, depending on what has happened in the market. Buying higher than face value is known as buying at a premium.

An original-issue discount (OID) security on the other hand, is a security that generally is issued for a price less than its stated redemption price at maturity. The OID is the difference between the stated maturity price and the price when issued. OID is considered to be a form of interest and must be amortized for tax purposes. Purchases in the secondary market are often at yields that are different than the original yield at issue, requiring the investor to make an adjustment on their tax return.

One exception to the normal rules for OID securities pertain to junior subordinated debt securities. When initially issued these securities are deemed to carry a remote contingency that the stated interest will not be paid in a timely fashion to the investor, making the securities exempt from OID under Treasury regulations. However, if the payment of interest is deferred or if the interest was determined not to carry the remote contingency, the securities are treated as if they were issued under OID at issuance.

Amortization or accretion calculations are used to adjust the cost basis from the purchase amount to the expected redemption amount. This spreads out the gain or loss over the remaining life of the bond instead of recognizing the gain or loss in the year of the bond's redemption. Such calculations are performed in accordance with the "constant yield" method. When an investor buys a bond, the yield is based on the purchase price and purchase date, and — until the investor disposes of a security — the same yield is used to calculate the amortization of the premium or the accretion of the discount. The cost basis changes daily to reflect these adjustments.

It may be helpful to look at two hypothetical examples of bond purchases. These examples are for informational purposes only; the numbers are hypothetical and are not intended to show any specific outcomes.

Example 1: Amortization of a premium

Sam purchases a 10-year bond at a premium for \$1,100. The bond has a 7% coupon, and Sam knows that the bond will mature at \$1,000. He is willing to pay the premium so that he can receive the 7% coupon payments, but since he paid a \$100 premium for the bond, the yield to maturity is reduced to 5.65%.

Let's say Sam sells the bond five years after purchase for \$1,080. The yield to maturity at the time of purchase was 5.65%, and the current price of a 7% bond with five years left to maturity at a yield to maturity of 5.65% is \$1,050. The amortized cost of \$1,050 with the sale price of \$1,080 results in a long-term gain of \$30 at the time the bond is sold.

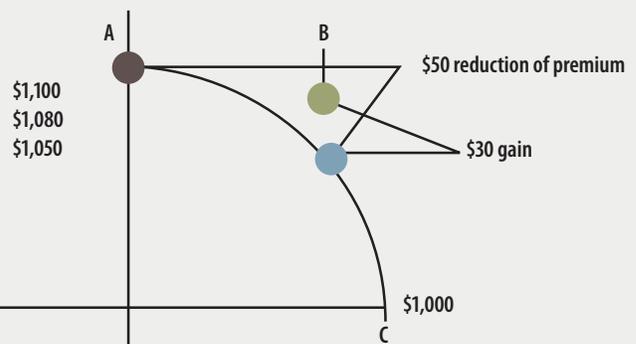
Bond is bought on date A for \$1,100. Maturity date is date C.

Bond is sold on date B for \$1,080.

Amortized cost basis on bond is \$1,050.

Amortization = \$1,100 minus \$1,050 = \$50 reduction of premium.

Capital gain = \$1,080 minus \$1,050 OR \$30 capital gain.



An adjusted cost basis is needed to accurately report gains or losses in the event of calls, sales or other redemptions prior to maturity.

Example 2: Accretion of a discount

Denise purchases a zero-coupon Treasury (collectively known as Treasury STRIPS) at a discount for \$900. The bond is due in three years for \$1,000, resulting in a yield to maturity of 4.50%. Although Denise will not receive income payments each year, the investment is compounding (accreting) at a rate of 4.50%. The IRS requires Denise to pay taxes on the accreted income even though it is only a paper gain at this point and no payment is physically received.

If Denise decides to sell the bond prior to maturity, she will need to know its adjusted cost basis to determine the proportion of the selling price that is attributable to ordinary income separate from capital gains or losses. For instance, if she sells the bond two years after purchase for \$980, the adjusted cost, based on a yield to maturity at purchase of 4.50% would be \$950, translating to a \$30 capital gain and \$50 of ordinary interest income.

The numbers

Your Financial Advisor can provide a report that displays your purchase cost, purchase price, adjusted cost and adjusted price for any securities you purchase.

Amortization and accretion adjustments are calculated on the following types of securities:

- Municipal bonds
- Treasury notes and bonds
- STRIPS, FICOs and similar stripped securities
- Federal agencies
- Corporate bonds (accretion only)
- Certificates of deposit (if purchased as securities)

Amortization and accretion adjustments are not calculated on the following types of securities:

- Treasury bills and other discount securities with maturities of less than one year
- Variable-rate securities
- Equity-linked securities
- Convertible securities
- Tax lots with insufficient data (e.g., no purchase price, no purchase date)

Some securities are subject to various cost-basis adjustments that are not related to amortization or accretion. These include master limited partnerships, unit investment trusts (UITs), contingent-payment debt instruments, mortgage-backed securities (pass-throughs and collateralized mortgage obligations), Treasury inflation-protected securities and structured products.

Important note

The Forms 1099 that we provide to the IRS include only the proceeds of a sale or redemption and the required OID on original-issue discount or zero-discount bonds. We do not report any cost-basis information to the IRS.

This document is not intended to be used as tax guidance. Wells Fargo Advisors is not a legal or tax advisor. For guidance on the tax implications of amortization and accretion, please contact your tax advisor.

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