

cal and Miscellaneous Revenue Act of 1988. The regulations will provide needed guidance to holders and issuers of debt instruments.

DATES: *Effective Date:* March 2, 1998.

Applicability date: For dates of applicability of the final regulations, see **Effective Dates** under SUPPLEMENTARY INFORMATION.

FOR FURTHER INFORMATION CONTACT: William E. Blanchard, (202) 622-3950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-1491. Responses to these collections of information are required by the IRS to determine whether a holder of a bond has elected to amortize bond premium and whether an issuer or a holder has changed its method of accounting for premium.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from 0.25 hours to 0.75 hours, depending on individual circumstances, with an estimated average of 0.5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to the collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and

tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Sections 1.171-1 through 1.171-4 of the Income Tax Regulations were promulgated in 1957 and last amended in 1968. In the Tax Reform Act of 1986, section 171(b) was amended to require that bond premium be amortized by reference to a constant yield. In the Technical and Miscellaneous Revenue Act of 1988, section 171(e) was amended to require that amortizable bond premium be treated as an offset to interest income.

On June 27, 1996, the IRS published a notice of proposed rulemaking in the **Federal Register** (61 F.R. 33396 [FI-48-95, 1996-2 C.B. 449]) relating to the federal income tax treatment of bond premium and bond issuance premium. A public hearing was not held because no one requested to speak at the hearing that had been scheduled for October 23, 1996. The IRS did receive a few comments on the proposed regulations. The proposed regulations, with certain changes to respond to the comments, are adopted as final regulations.

Explanation of Provisions

In general, bond premium arises when a holder acquires a bond for more than the principal amount of the bond. Similarly, bond issuance premium arises when an issuer issues a bond for more than the principal amount of the bond. A holder will purchase, and an issuer will issue, a bond for more than its principal amount when the stated interest rate on the bond is higher than the current market yield for the bond.

The holder's treatment of bond premium is addressed in §§1.171-1 through 1.171-5. The issuer's treatment of bond issuance premium is addressed in §1.163-13. In each case, the amortization of premium is based on constant yield principles. For this reason, the final regulations use concepts and definitions from the original issue discount (OID) regulations (in general, see §§1.1271-1 through 1.1275-7T).

Determination of Bond Premium

Under the proposed regulations, bond premium is defined as the excess of a

Section 171.—Amortizable Bond Premium

26 CFR 1.171: Bond premium.

T.D. 8746

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Amortizable Bond Premium

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the federal income tax treatment of bond premium and bond issuance premium. The regulations reflect changes to the law made by the Tax Reform Act of 1986 and the Techni-

holder's basis in a bond over the sum of the remaining amounts payable on the bond other than payments of qualified stated interest. The holder generally determines the amount of bond premium as of the date the holder acquires the bond.

The proposed regulations provide special rules that limit a holder's basis solely for purposes of determining bond premium. For example, if a bond is convertible into stock of the issuer at the holder's option, for purposes of determining bond premium, the holder must reduce its basis in the bond by the value of the conversion option. This reduction prevents the holder from inappropriately amortizing the cost of the embedded conversion option.

The final regulations adopt the rules of the proposed regulations for determining the amount of bond premium, if any, on a bond. However, in response to comments, the final regulations clarify the determination of basis in the case of a convertible bond acquired in a transferred basis transaction.

Amortization of Bond Premium

(a) In general

Under section 171, the holder of a taxable bond acquired at a premium may elect to amortize bond premium. The holder of a tax-exempt bond acquired at a premium must amortize the premium. As premium is amortized, the holder's basis in the bond is reduced by a corresponding amount under section 1016(a)(5).

Under the proposed regulations, a holder amortizes bond premium by offsetting qualified stated interest income with bond premium. An offset is calculated for each accrual period using constant yield principles. However, the offset for an accrual period is only taken into account when the holder takes qualified stated interest into account under the holder's regular method of accounting. Thus, a holder using the cash receipts and disbursements method of accounting does not take bond premium into account until a qualified stated interest payment is received.

The final regulations adopt the rules in the proposed regulations for amortizing bond premium.

(b) Excess premium

For certain bonds (for example, bonds that pay a variable rate of interest or that

provide for an interest holiday), the amount of bond premium allocable to an accrual period could exceed the amount of qualified stated interest allocable to that period. The proposed regulations address this situation by providing that the excess bond premium is not allowed as a deduction but is carried forward to future accrual periods.

Several commentators stated that this excess premium should be allowable as a current deduction for the accrual period in which the excess occurs. In response to these comments, the final regulations adopt rules for excess premium that are similar to the rules for negative adjustments on contingent payment debt instruments and deflation adjustments on inflation-indexed debt instruments. Under the final regulations, any excess bond premium allocable to an accrual period is deductible by the holder under section 171(a)(1) for the accrual period. The amount deductible, however, is limited by the amount of the holder's prior income inclusions on the bond. If any of the excess bond premium is not deductible under section 171(a)(1), this amount is carried forward to the next accrual period and is treated as bond premium allocable to that period.

Bonds Subject to Certain Contingencies

If a bond provides for one or more alternative payment schedules, the yield of the bond cannot be determined without making assumptions about the actual payment schedule. The OID regulations provide rules for making these assumptions. For example, the rules assume that an issuer will exercise a call option if doing so would minimize the yield of the debt instrument and that a holder will exercise a put option if doing so would maximize the yield of the debt instrument.

The proposed regulations under section 171 generally use similar assumptions to determine the holder's yield on a bond that provides for alternative payment schedules. However, in the case of an issuer's option on a taxable bond, the proposed regulations reverse the assumption in the OID regulations by assuming that the issuer will exercise the option only if doing so would increase the yield on the bond. See section 171(b)(1)(B)(ii). Thus, under the proposed regulations, a holder generally must amortize bond premium

on a taxable bond by reference to the stated maturity date, even if it appears likely the bond will be called. In this case, if the bond is actually called, the proposed regulations provide that the holder may deduct the unamortized premium. If the bond is partially called and the partial call is not a pro-rata prepayment, the proposed regulations do not allow the holder to deduct a portion of the unamortized premium. Instead, the holder must recompute the yield of the bond on the date of the partial call and amortize the remaining premium by reference to the recomputed yield.

In general, the final regulations adopt the rules of the proposed regulations. In response to a comment, the final regulations limit the issuer rule for taxable bonds to call options.

Bond Issuance Premium

Under existing §1.61-12(c), a corporate issuer treats premium received upon issuance of a bond as a separate item of income. Over the term of the bond, the premium is taken into income, and the full amount of the stated interest is deducted. The proposed regulations revise the treatment of bond issuance premium. Under the proposed regulations, bond issuance premium is amortized as an offset to the issuer's otherwise allowable interest deduction, not as a separate item of income. The amount of bond issuance premium amortized in any period is based on a constant yield. In addition, the proposed regulations apply to all issuers, not just corporate issuers.

In general, the final regulations adopt the rules in the proposed regulations for bond issuance premium. However, the final regulations contain several important changes from the proposed regulations. First, in response to comments, the final regulations clarify the treatment of a debt instrument subject to an alternative payment schedule by explicitly cross-referencing §1.1272-1(c). Second, the final regulations provide that, in the case of a debt instrument subject to a mandatory sinking fund provision, the issuer must determine the payment schedule by assuming that a pro rata portion of the debt instrument will be called under the sinking fund provision. This rule produces more economic interest accruals than the

accruals determined by ignoring the sinking fund provision as under the proposed regulations. Third, the final regulations adopt rules for excess bond issuance premium allocable to an accrual period. These rules are similar to the rules for excess bond premium described above.

Aggregation Rules

Although the proposed regulations do not provide for an aggregate method of accounting for premium, comments were requested on the need for an aggregate method. Because no comments were received, the final regulations do not provide rules for an aggregate method of accounting for premium.

Bonds Not Subject to the Final Regulations

The final regulations generally apply to bonds acquired or issued at a premium. Certain bonds, however, are excluded from the application of the final regulations. For example, the final regulations exclude debt instruments described in section 1272(a)(6)(C) (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration). No inference is intended regarding the treatment of debt instruments described in section 1272(a)(6)(C).

Effective Dates

The final regulations relating to bond premium are effective for bonds acquired on or after March 2, 1998. However, if a holder makes the election to amortize bond premium for the taxable year containing March 2, 1998, or any subsequent taxable year, the regulations apply to bonds held on or after the first day of the taxable year in which the election is made.

The final regulations relating to bond issuance premium apply to debt instruments issued on or after March 2, 1998.

The final regulations also provide automatic consent for a taxpayer to change its method of accounting for premium in certain circumstances. Because the change is made on a cut-off basis, no items of income or deduction are omitted or duplicated. Therefore, no adjustment under section 481 is allowed.

Special Analyses

It is hereby certified that these regulations do not have significant economic impact on a substantial number of small entities. This certification is based upon the fact that the regulations merely require a taxpayer to attach to the taxpayer's return a statement that indicates whether the taxpayer is making an election under section 171 or is changing its accounting method for bond premium or bond issuance premium. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

Several persons from the Office of Assistant Chief Counsel (Financial Institutions and Products) and the Treasury Department participated in the development of these regulations.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.171-2 also issued under 26 U.S.C. 171(e).

Section 1.171-3 also issued under 26 U.S.C. 171(e).

Section 1.171-4 also issued under 26 U.S.C. 171(c). * * *

Par. 2. Section 1.61-12 is amended by revising paragraph (c) to read as follows:

§1.61-12 *Income from discharge of indebtedness.*

* * * * *

(c) *Issuance and repurchase of debt instruments*—(1) *Issuance.* An issuer does not realize gain or loss upon the issuance of a debt instrument. For rules relating to an issuer's interest deduction for a debt instrument issued with bond issuance premium, see §1.163-13.

(2) *Repurchase*—(i) *In general.* An issuer does not realize gain or loss upon the repurchase of a debt instrument. However, if a debt instrument provides for payments denominated in, or determined by reference to, a nonfunctional currency, an issuer may realize a currency gain or loss upon the repurchase of the instrument. See section 988 and the regulations thereunder. For purposes of this paragraph (c)(2), the term *repurchase* includes the retirement of a debt instrument, the conversion of a debt instrument into stock of the issuer, and the exchange (including an exchange under section 1001) of a newly issued debt instrument for an existing debt instrument.

(ii) *Repurchase at a discount.* An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of §1.1275-1(b)). The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price. See section 108 and the regulations thereunder for additional rules relating to income from discharge of indebtedness. For example, to determine the repurchase price of a debt instrument that is repurchased through the issuance of a new debt instrument, see section 108(e)(10).

(iii) *Repurchase at a premium.* An issuer may be entitled to a repurchase premium deduction upon the repurchase of a debt instrument for an amount greater than its adjusted issue price (within the meaning of §1.1275-1(b)). See §1.163-7(c) for the treatment of repurchase premium.

(iv) *Effective date.* This paragraph (c)(2) applies to debt instruments repurchased on or after March 2, 1998.

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Par. 3. Section 1.163-13 is added to read as follows:

(a) *General rule.* If a debt instrument is issued with bond issuance premium, this section limits the amount of the issuer's interest deduction otherwise allowable under section 163(a). In general, the issuer determines its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period. Bond issuance premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond issuance premium is intended to generally conform the treatment of debt instruments having bond issuance premium with those having original issue discount. Unless otherwise provided, the terms used in this section have the same meaning as those terms in section 163(e), sections 1271 through 1275, and the corresponding regulations. Moreover, unless otherwise provided, the provisions of this section apply in a manner consistent with those of section 163(e), sections 1271 through 1275, and the corresponding regulations. In addition, the anti-abuse rule in §1.1275-2(g) applies for purposes of this section. For rules dealing with the treatment of bond premium by a holder, see §§1.171-1 through 1.171-5.

(b) *Exceptions.* This section does not apply to—

(1) A debt instrument described in section 1272(a)(6)(C) (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration); or

(2) A debt instrument to which §1.1275-4 applies (relating to certain debt instruments that provide for contingent payments).

(c) *Bond issuance premium.* Bond issuance premium is the excess, if any, of the issue price of a debt instrument over its stated redemption price at maturity. For purposes of this section, the issue price of a convertible bond (as defined in §1.171-1(e)(1)(iii)(C)) does not include an amount equal to the value of the conversion option (as determined under §1.171-1(e)(1)(iii)(A)).

(d) *Offsetting qualified stated interest with bond issuance premium—(1) In general.* An issuer amortizes bond issuance premium by offsetting the qualified stated

interest allocable to an accrual period with the bond issuance premium allocable to the accrual period. This offset occurs when the issuer takes the qualified stated interest into account under its regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See §1.446-2(b) to determine the accrual period to which qualified stated interest is allocable and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond issuance premium allocable to an accrual period.* The bond issuance premium allocable to an accrual period is determined under this paragraph (d)(3). Within an accrual period, the bond issuance premium allocable to the period accrues ratably.

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield to maturity of a debt instrument is determined under the rules of §1.1272-1(b)-(1)(i).

(ii) *Step two: Determine the accrual periods.* The accrual periods are determined under the rules of §1.1272-1(b)-(1)(ii).

(iii) *Step three: Determine the bond issuance premium allocable to the accrual period.* The bond issuance premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the adjusted issue price at the beginning of the accrual period and the yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in §1.1272-1(b)(4) apply in determining the bond issuance premium allocable to an accrual period.

(4) *Bond issuance premium in excess of qualified stated interest—(i) Ordinary income.* If the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated as ordinary income by the issuer for the accrual period. However, the amount treated as ordinary income is limited to the amount by which the issuer's total interest deductions on the debt instrument in prior accrual periods exceed the total amount treated by the issuer as ordinary income on the debt instrument in prior accrual periods.

(ii) *Carryforward.* If the bond issuance premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as ordinary income for the accrual period under paragraph (d)(4)(i) of this section, the excess is carried forward to the next accrual period and is treated as bond issuance premium allocable to that period. If a carryforward exists on the date the debt instrument is retired, the carryforward is treated as ordinary income on that date.

(e) *Special rules—(1) Variable rate debt instruments.* An issuer determines bond issuance premium on a variable rate debt instrument by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument. The issuer also allocates any bond issuance premium among the accrual periods by reference to the equivalent fixed rate debt instrument. The issuer constructs the equivalent fixed rate debt instrument, as of the issue date, by using the principles of §1.1275-5(e).

(2) *Inflation-indexed debt instruments.* An issuer determines bond issuance premium on an inflation-indexed debt instrument by assuming that there will be no inflation or deflation over the term of the instrument. The issuer also allocates any bond issuance premium among the accrual periods by assuming that there will be no inflation or deflation over the term of the instrument. The bond issuance premium allocable to an accrual period offsets qualified stated interest allocable to the period. Notwithstanding paragraph (d)(4) of this section, if the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment under §1.1275-7T(f)(1)(ii). See §1.1275-7T for other rules relating to inflation-indexed debt instruments.

(3) *Certain debt instruments subject to contingencies—(i) In general.* Except as provided in paragraph (e)(3)(ii) of this section, the rules of §1.1272-1(c) apply to determine a debt instrument's payment schedule for purposes of this section. For example, an issuer uses the payment schedule determined under §1.1272-1(c) to determine the amount, if any, of bond issuance premium on the debt instrument, the yield and maturity of the debt instru-

ment, and the allocation of bond issuance premium to an accrual period.

(ii) *Mandatory sinking fund provision.* Notwithstanding paragraph (e)(3)(i) of this section, if a debt instrument is subject to a mandatory sinking fund provision described in §1.1272-1(c)(3), the issuer must determine the payment schedule by assuming that a pro rata portion of the debt instrument will be called under the sinking fund provision.

(4) *Remote and incidental contingencies.* For purposes of determining the amount of bond issuance premium and allocating bond issuance premium among accrual periods, if a bond provides for a contingency that is remote or incidental (within the meaning of §1.1275-2(h)), the issuer takes the contingency into account under the rules for remote and incidental contingencies in §1.1275-2(h).

(f) *Example.* The following example illustrates the rules of this section:

Example—(i) Facts. On February 1, 1999, X issues for \$110,000 a debt instrument maturing on February 1, 2006, with a stated principal amount of \$100,000, payable at maturity. The debt instrument provides for unconditional payments of interest of \$10,000, payable on February 1 of each year. X uses the calendar year as its taxable year, X uses the cash receipts and disbursements method of accounting, and X decides to use annual accrual periods ending on February 1 of each year. X's calculations assume a 30-day month and 360-day year.

(ii) *Amount of bond issuance premium.* The issue price of the debt instrument is \$110,000. Because the interest payments on the debt instrument are qualified stated interest, the stated redemption price at maturity of the debt instrument is \$100,000. Therefore, the amount of bond issuance premium is \$10,000 (\$110,000-\$100,000).

(iii) *Bond issuance premium allocable to the first accrual period.* Based on the payment schedule and the issue price of the debt instrument, the yield of the debt instrument is 8.07 percent, compounded annually. (Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention.) The bond issuance premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period (\$10,000) over the product of the adjusted issue price at the beginning of the period (\$110,000) and the yield (8.07 percent, compounded annually). Therefore, the bond issuance premium allocable to the accrual period is \$1,118.17 (\$10,000-\$8,881.83).

(iv) *Premium used to offset interest.* Although X makes an interest payment of \$10,000 on February 1, 2000, X only deducts interest of \$8,881.83, the qualified stated interest allocable to the period (\$10,000) offset with the bond issuance premium allocable to the period (\$1,118.17).

(g) *Effective date.* This section applies to debt instruments issued on or after March 2, 1998.

(h) *Accounting method changes—(1) Consent to change.* An issuer required to change its method of accounting for bond issuance premium to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446-1(e). Paragraph (h)(2) of this section provides the Commissioner's automatic consent for certain changes.

(2) *Automatic consent.* The Commissioner grants consent for an issuer to change its method of accounting for bond issuance premium on debt instruments issued on or after March 2, 1998. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (h)(2) applies provided—

(i) The change is made to comply with this section;

(ii) The change is made for the first taxable year for which the issuer must account for a debt instrument under this section; and

(iii) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

Par. 4. Sections 1.171-1 through 1.171-4 are revised to read as follows:

§1.171-1 Bond premium.

(a) *Overview—(1) In general.* This section and §§1.171-2 through 1.171-5 provide rules for the determination and amortization of bond premium by a holder. In general, a holder amortizes bond premium by offsetting the interest allocable to an accrual period with the premium allocable to that period. Bond premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond premium is intended to generally conform the treatment of bond premium to the treatment of original issue discount under sections 1271 through 1275. Unless otherwise provided, the terms used in this section and §§1.171-2 through 1.171-5 have the same meaning as those terms in sections 1271 through 1275 and the corresponding regulations. Moreover, unless otherwise provided, the provisions of this section and §§1.171-2 through 1.171-5 apply in

a manner consistent with those of sections 1271 through 1275 and the corresponding regulations. In addition, the anti-abuse rule in §1.1275-2(g) applies for purposes of this section and §§1.171-2 through 1.171-5.

(2) *Cross-references.* For rules dealing with the adjustments to a holder's basis to reflect the amortization of bond premium, see §1.1016-5(b). For rules dealing with the treatment of bond issuance premium by an issuer, see §1.163-13.

(b) *Scope—(1) In general.* Except as provided in paragraph (b)(2) of this section and §1.171-5, this section and §§1.171-2 through 1.171-4 apply to any bond that, upon its acquisition by the holder, is held with bond premium. For purposes of this section and §§1.171-2 through 1.171-5, the term bond has the same meaning as the term debt instrument in §1.1275-1(d).

(2) *Exceptions.* This section and §§1.171-2 through 1.171-5 do not apply to—

(i) A bond described in section 1272(a)-(6)(C) (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration);

(ii) A bond to which §1.1275-4 applies (relating to certain debt instruments that provide for contingent payments);

(iii) A bond held by a holder that has made a §1.1272-3 election with respect to the bond;

(iv) A bond that is stock in trade of the holder, a bond of a kind that would properly be included in the inventory of the holder if on hand at the close of the taxable year, or a bond held primarily for sale to customers in the ordinary course of the holder's trade or business; or

(v) A bond issued before September 28, 1985, unless the bond bears interest and was issued by a corporation or by a government or political subdivision thereof.

(c) *General rule—(1) Tax-exempt obligations.* A holder must amortize bond premium on a bond that is a tax-exempt obligation. See §1.171-2(c) Example 4.

(2) *Taxable bonds.* A holder may elect to amortize bond premium on a taxable bond. Except as provided in paragraph (c)(3) of this section, a taxable bond is any bond other than a tax-exempt obligation. See §1.171-4 for rules relating to

the election to amortize bond premium on a taxable bond.

(3) Bonds the interest on which is partially excludable. For purposes of this section and §§1.171–2 through 1.171–5, a bond the interest on which is partially excludable from gross income is treated as two instruments, a tax-exempt obligation and a taxable bond. The holder's basis in the bond and each payment on the bond are allocated between the two instruments based on a reasonable method.

(d) *Determination of bond premium—*

(1) *In general.* A holder acquires a bond at a premium if the holder's basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments of qualified stated interest). This excess is bond premium, which is amortizable under §1.171–2.

(2) *Additional rules for amounts payable on certain bonds.* Additional rules apply to determine the amounts payable on a variable rate debt instrument, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules, and a bond that provides for remote or incidental contingencies. See §1.171–3.

(e) *Basis.* A holder determines its basis in a bond under this paragraph (e). This determination of basis applies only for purposes of this section and §§1.171–2 through 1.171–5. Because of the application of this paragraph (e), the holder's basis in the bond for purposes of these sections may differ from the holder's basis for determining gain or loss on the sale or exchange of the bond.

(1) *Determination of basis—(i) In general.* In general, the holder's basis in the bond is the holder's basis for determining loss on the sale or exchange of the bond.

(ii) *Bonds acquired in certain exchanges.* If the holder acquired the bond in exchange for other property (other than in a reorganization defined in section 368) and the holder's basis in the bond is determined in whole or in part by reference to the holder's basis in the other property, the holder's basis in the bond may not exceed its fair market value immediately after the exchange. See paragraph (f) *Example 1* of this section. If the bond is acquired in a reorganization, see section 171(b)(4)(B).

(iii) *Convertible bonds—(A) General rule.* If the bond is a convertible bond, the holder's basis in the bond is reduced by an amount equal to the value of the conversion option. The value of the conversion option may be determined under any reasonable method. For example, the holder may determine the value of the conversion option by comparing the market price of the convertible bond to the market prices of similar bonds that do not have conversion options. See paragraph (f) *Example 2* of this section.

(B) *Convertible bonds acquired in certain exchanges.* If the bond is a convertible bond acquired in a transaction described in paragraph (e)(1)(ii) of this section, the holder's basis in the bond may not exceed its fair market value immediately after the exchange reduced by the value of the conversion option.

(C) *Definition of convertible bond.* A convertible bond is a bond that provides the holder with an option to convert the bond into stock of the issuer, stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.

(2) *Basis in bonds held by certain transferees.* Notwithstanding paragraph (e)(1) of this section, if the bond is transferred basis property (as defined in section 7701(a)(43)) and the transferor had acquired the bond at a premium, the holder's basis in the bond is—

(i) The holder's basis for determining loss on the sale or exchange of the bond; reduced by

(ii) Any amounts that the transferor could not have amortized under this paragraph (e) or under §1.171–4(c), except to the extent that the holder's basis already reflects a reduction attributable to such nonamortizable amounts.

(f) *Examples.* The following examples illustrate the rules of this section:

Example 1. Bond received in liquidation of a partnership interest—(i) Facts. PR is a partner in partnership PRS. PRS does not have any unrealized receivables or inventory items as defined in section 751. On January 1, 1998, PRS distributes to PR a taxable bond, issued by an unrelated corporation, in liquidation of PR's partnership interest. At that time, the fair market value of PR's partnership interest is \$40,000 and the basis is \$100,000. The fair market value of the bond is \$40,000.

(ii) *Determination of basis.* Under section 732(b), PR's basis in the bond is equal to PR's basis in the partnership interest. Therefore, PR's basis for

determining loss on the sale or exchange of the bond is \$100,000. However, because the distribution is treated as an exchange for purposes of section 171(b)(4), PR's basis in the bond is \$40,000 for purposes of this section and §§1.171–2 through 1.171–5. See paragraph (e)(1)(ii) of this section.

Example 2. Convertible bond—(i) Facts. On January 1, 1998, A purchases for \$1,100 B corporation's bond maturing on January 1, 2001, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$30 on January 1 and July 1 of each year. In addition, the bond is convertible into 15 shares of B corporation stock at the option of the holder. On January 1, 1998, B corporation's nonconvertible, publicly-traded, three-year debt with a similar credit rating trades at a price that reflects a yield of 6.75 percent, compounded semiannually.

(ii) *Determination of basis.* A's basis for determining loss on the sale or exchange of the bond is \$1,100. As of January 1, 1998, discounting the remaining payments on the bond at the yield at which B's similar nonconvertible bonds trade (6.75 percent, compounded semiannually) results in a present value of \$980. Thus, the value of the conversion option is \$120. Under paragraph (e)(1)(iii)(A) of this section, A's basis is \$980 (\$1,100–\$120) for purposes of this section and §§1.171–2 through 1.171–5. The sum of all amounts payable on the bond other than qualified stated interest is \$1,000. Because A's basis (as determined under paragraph (e)(1)(iii)(A) of this section) does not exceed \$1,000, A does not acquire the bond at a premium.

§1.171–2 Amortization of bond premium.

(a) *Offsetting qualified stated interest with premium—(1) In general.* A holder amortizes bond premium by offsetting the qualified stated interest allocable to an accrual period with the bond premium allocable to the accrual period. This offset occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See §1.446–2(b) to determine the accrual period to which qualified stated interest is allocable and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond premium allocable to an accrual period.* The bond premium allocable to an accrual period is determined under this paragraph (a)(3). Within an accrual period, the bond premium allocable to the period accrues ratably.

(i) *Step one: Determine the holder's yield.* The holder's yield is the discount rate that, when used in computing the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to the holder's basis in the

bond as determined under §1.171-1(e). For this purpose, the remaining payments include only payments to be made after the date the holder acquires the bond. The yield is calculated as of the date the holder acquires the bond, must be constant over the term of the bond, and must be calculated to at least two decimal places when expressed as a percentage.

(ii) *Step two: Determine the accrual periods.* A holder determines the accrual periods for the bond under the rules of §1.1272-1(b)(1)(ii).

(iii) *Step three: Determine the bond premium allocable to the accrual period.* The bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the holder's adjusted acquisition price (as defined in paragraph (b) of this section) at the beginning of the accrual period and the holder's yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in §1.1272-1(b)(4) apply in determining the bond premium allocable to an accrual period.

(4) *Bond premium in excess of qualified stated interest—(i) Taxable bonds—(A) Bond premium deduction.* In the case of a taxable bond, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated by the holder as a bond premium deduction under section 171(a)(1) for the accrual period. However, the amount treated as a bond premium deduction is limited to the amount by which the holder's total interest inclusions on the bond in prior accrual periods exceed the total amount treated by the holder as a bond premium deduction on the bond in prior accrual periods. A deduction determined under this paragraph (a)(4)(i)(A) is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions). See *Example 1* of §1.171-3(e).

(B) *Carryforward.* If the bond premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as a deduction for the accrual period under paragraph (a)(4)(i)(A) of this section, the excess is carried forward to the next accrual period and is treated as bond premium allocable to that period.

(ii) *Tax-exempt obligations.* In the case of a tax-exempt obligation, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is a nondeductible loss. If a regulated investment company (RIC) within the meaning of section 851 has excess bond premium for an accrual period that would be a nondeductible loss under the prior sentence, the RIC must use this excess bond premium to reduce its tax-exempt interest income on other tax-exempt obligations held during the accrual period.

(5) *Additional rules for certain bonds.* Additional rules apply to determine the amortization of bond premium on a variable rate debt instrument, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules, and a bond that provides for remote or incidental contingencies. See §1.171-3.

(b) *Adjusted acquisition price.* The adjusted acquisition price of a bond at the beginning of the first accrual period is the holder's basis as determined under §1.171-1(e). Thereafter, the adjusted acquisition price is the holder's basis in the bond decreased by—

(1) The amount of bond premium previously allocable under paragraph (a)(3) of this section; and

(2) The amount of any payment previously made on the bond other than a payment of qualified stated interest.

(c) *Examples.* The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention. The examples are as follows:

Example 1. Taxable bond—(i) Facts. On February 1, 1999, A purchases for \$110,000 a taxable bond maturing on February 1, 2006, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest of \$10,000, payable on February 1 of each year. A uses the cash receipts and disbursements method of accounting, and A decides to use annual accrual periods ending on February 1 of each year.

(ii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest.

Therefore, the sum of all amounts payable on the bond (other than the interest payments) is \$100,000. Under §1.171-1, the amount of bond premium is \$10,000 (\$110,000-\$100,000).

(iii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the bond and A's basis in the bond, A's yield is 8.07 percent, compounded annually. The bond premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period (\$10,000) over the product of the adjusted acquisition price at the beginning of the period (\$110,000) and A's yield (8.07 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is \$1,118.17 (\$10,000-\$8,881.83).

(iv) *Premium used to offset interest.* Although A receives an interest payment of \$10,000 on February 1, 2000, A only includes in income \$8,881.83, the qualified stated interest allocable to the period (\$10,000) offset with bond premium allocable to the period (\$1,118.17). Under §1.1016-5(b), A's basis in the bond is reduced by \$1,118.17 on February 1, 2000.

Example 2. Alternative accrual periods—(i) Facts. The facts are the same as in *Example 1* of this paragraph (c) except that A decides to use semiannual accrual periods ending on February 1 and August 1 of each year.

(ii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the bond and A's basis in the bond, A's yield is 7.92 percent, compounded semiannually. The bond premium allocable to the accrual period ending on August 1, 1999, is the excess of the qualified stated interest allocable to the period (\$5,000) over the product of the adjusted acquisition price at the beginning of the period (\$110,000) and A's yield, stated appropriately taking into account the length of the accrual period (7.92 percent/2). Therefore, the bond premium allocable to the accrual period is \$645.29 (\$5,000-\$4,354.71). Although the accrual period ends on August 1, 1999, the qualified stated interest of \$5,000 is not taken into income until February 1, 2000, the date it is received. Likewise, the bond premium of \$645.29 is not taken into account until February 1, 2000. The adjusted acquisition price of the bond on August 1, 1999, is \$109,354.71 (the adjusted acquisition price at the beginning of the period (\$110,000) less the bond premium allocable to the period (\$645.29)).

(iii) *Bond premium allocable to the second accrual period.* Because the interval between payments of qualified stated interest contains more than one accrual period, the adjusted acquisition price at the beginning of the second accrual period must be adjusted for the accrued but unpaid qualified stated interest. See paragraph (a)(3)(iii) of this section and §1.1272-1(b)(4)(i)(B). Therefore, the adjusted acquisition price on August 1, 1999, is \$114,354.71 (\$109,354.71 + \$5,000). The bond premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period (\$5,000) over the product of the adjusted acquisition price at the beginning of the period (\$114,354.71) and A's yield, stated appropriately taking into account the length of the accrual period (7.92 percent/2). Therefore, the bond premium allocable to the accrual period is \$472.88 (\$5,000-\$4,527.12).

(iv) *Premium used to offset interest.* Although A receives an interest payment of \$10,000 on February 1, 2000, A only includes in income \$8,881.83, the qualified stated interest of \$10,000 (\$5,000 allocable to the accrual period ending on August 1, 1999, and \$5,000 allocable to the accrual period ending on February 1, 2000) offset with bond premium of \$1,118.17 (\$645.29 allocable to the accrual period ending on August 1, 1999, and \$472.88 allocable to the accrual period ending on February 1, 2000). As indicated in *Example 1* of this paragraph (c), this same amount would be taken into income at the same time had A used annual accrual periods.

Example 3. Holder uses accrual method of accounting—(i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c) except that A uses an accrual method of accounting. Thus, for the accrual period ending on February 1, 2000, the qualified stated interest allocable to the period is \$10,000, and the bond premium allocable to the period is \$1,118.17. Because the accrual period extends beyond the end of A's taxable year, A must allocate these amounts between the two taxable years.

(ii) *Amounts allocable to the first taxable year.* The qualified stated interest allocable to the first taxable year is \$9,166.67 ($\$10,000 \times 11/12$). The bond premium allocable to the first taxable year is \$1,024.99 ($\$1,118.17 \times 11/12$).

(iii) *Premium used to offset interest.* For 1999, A includes in income \$8,141.68, the qualified stated interest allocable to the period (\$9,166.67) offset with bond premium allocable to the period (\$1,024.99). Under §1.1016-5(b), A's basis in the bond is reduced by \$1,024.99 in 1999.

(iv) *Amounts allocable to the next taxable year.* The remaining amounts of qualified stated interest and bond premium allocable to the accrual period ending on February 1, 2000, are taken into account for the taxable year ending on December 31, 2000.

Example 4. Tax-exempt obligation—(i) Facts. On January 15, 1999, C purchases for \$120,000 a tax-exempt obligation maturing on January 15, 2006, with a stated principal amount of \$100,000, payable at maturity. The obligation provides for unconditional payments of interest of \$9,000, payable on January 15 of each year. C uses the cash receipts and disbursements method of accounting, and C decides to use annual accrual periods ending on January 15 of each year.

(ii) *Amount of bond premium.* The interest payments on the obligation are qualified stated interest. Therefore, the sum of all amounts payable on the obligation (other than the interest payments) is \$100,000. Under §1.171-1, the amount of bond premium is \$20,000 ($\$120,000 - \$100,000$).

(iii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the obligation and C's basis in the obligation, C's yield is 5.48 percent, compounded annually. The bond premium allocable to the accrual period ending on January 15, 2000, is the excess of the qualified stated interest allocable to the period (\$9,000) over the product of the adjusted acquisition price at the beginning of the period (\$120,000) and C's yield (5.48 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is \$2,420.55 ($\$9,000 - \$6,579.45$).

(iv) *Premium used to offset interest.* Although C receives an interest payment of \$9,000 on January 15, 2000, C only receives tax-exempt interest in-

come of \$6,579.45, the qualified stated interest allocable to the period (\$9,000) offset with bond premium allocable to the period (\$2,420.55). Under §1.1016-5(b), C's basis in the obligation is reduced by \$2,420.55 on January 15, 2000.

§1.171-3 *Special rules for certain bonds.*

(a) *Variable rate debt instruments.* A holder determines bond premium on a variable rate debt instrument by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument. The holder also allocates any bond premium among the accrual periods by reference to the equivalent fixed rate debt instrument. The holder constructs the equivalent fixed rate debt instrument, as of the date the holder acquires the variable rate debt instrument, by using the principles of §1.1275-5(e). See paragraph (e) *Example 1* of this section.

(b) *Inflation-indexed debt instruments.* A holder determines bond premium on an inflation-indexed debt instrument by assuming that there will be no inflation or deflation over the remaining term of the instrument. The holder also allocates any bond premium among the accrual periods by assuming that there will be no inflation or deflation over the remaining term of the instrument. The bond premium allocable to an accrual period offsets qualified stated interest allocable to the period. Notwithstanding §1.171-2(a)(4), if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment under §1.1275-7T(f)(1)(i). See §1.1275-7T for other rules relating to inflation-indexed debt instruments.

(c) *Yield and remaining payment schedule of certain bonds subject to contingencies—(1) Applicability.* This paragraph (c) provides rules that apply in determining the yield and remaining payment schedule of certain bonds that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the date the holder acquires the bond (the acquisition date) and the bond is subject to paragraph (c)(2), (3), or (4) of this section. A bond does not pro-

vide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See §1.1275-4 for the treatment of a bond that provides for a contingency that is not described in this paragraph (c).

(2) *Remaining payment schedule that is significantly more likely than not to occur.* If, based on all the facts and circumstances as of the acquisition date, a single remaining payment schedule for a bond is significantly more likely than not to occur, this remaining payment schedule is used to determine and amortize bond premium under §§1.171-1 and 1.171-2.

(3) *Mandatory sinking fund provision.* Notwithstanding paragraph (c)(2) of this section, if a bond is subject to a mandatory sinking fund provision described in §1.1272-1(c)(3), the provision is ignored for purposes of determining and amortizing bond premium under §§1.171-1 and 1.171-2.

(4) *Treatment of certain options—(i) Applicability.* Notwithstanding paragraphs (c)(2) and (3) of this section, the rules of this paragraph (c)(4) determine the remaining payment schedule of a bond that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the remaining term of the bond, to alter the bond's remaining payment schedule.

(ii) *Operating rules.* A holder determines the remaining payment schedule of a bond by assuming that each option will (or will not) be exercised under the following rules:

(A) *Issuer options.* In general, the issuer is deemed to exercise or not exercise an option or combination of options in the manner that minimizes the holder's yield on the obligation. However, the issuer of a taxable bond is deemed to exercise or not exercise a call option or combination of call options in the manner that maximizes the holder's yield on the bond.

(B) *Holder options.* A holder is deemed to exercise or not exercise an option or combination of options in the manner that maximizes the holder's yield on the bond.

(C) *Multiple options.* If both the issuer and the holder have options, the rules of paragraphs (c)(4)(ii)(A) and (B) of this section are applied to the options in the order that they may be exercised. Thus,

the deemed exercise of one option may eliminate other options that are later in time.

(5) *Subsequent adjustments*—(i) *In general.* Except as provided in paragraph (c)(5)(ii) of this section, if a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(4) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to paragraph (c) of this section (a change in circumstances), then solely for purposes of section 171, the bond is treated as retired and reacquired by the holder on the date of the change in circumstances for an amount equal to the adjusted acquisition price of the bond as of that date. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in §1.1275-2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the bond. See paragraph (e) *Example 2* of this section.

(ii) *Bond premium deduction on the issuer's call of a taxable bond.* If a change in circumstances results from an issuer's call of a taxable bond or a partial call that is a pro-rata prepayment, the holder may deduct as bond premium an amount equal to the excess, if any, of the holder's adjusted acquisition price of the bond over the greater of—

(A) The amount received on redemption; and

(B) The amounts that would have been payable under the bond (other than payments of qualified stated interest) if no change in circumstances had occurred.

(d) *Remote and incidental contingencies.* For purposes of determining and amortizing bond premium, if a bond provides for a contingency that is remote or incidental (within the meaning of §1.1275-2(h)), the holder takes the contingency into account under the rules for remote and incidental contingencies in §1.1275-2(h).

(e) *Examples.* The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention. The examples are as follows:

Example 1. Variable rate debt instrument—(i) *Facts.* On March 1, 1999, E purchases for \$110,000 a taxable bond maturing on March 1, 2007, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest on March 1 of each year based on the percentage appreciation of a nationally-known commodity index. On March 1, 1999, it is reason-

ably expected that the bond will yield 12 percent, compounded annually. E uses the cash receipts and disbursements method of accounting, and E decides to use annual accrual periods ending on March 1 of each year. Assume that the bond is a variable rate debt instrument under §1.1275-5.

(ii) *Amount of bond premium.* Because the bond is a variable rate debt instrument, E determines and amortizes its bond premium by reference to the equivalent fixed rate debt instrument constructed for the bond as of March 1, 1999. Because the bond provides for interest at a single objective rate that is reasonably expected to yield 12 percent, compounded annually, the equivalent fixed rate debt instrument for the bond is an eight-year bond with a principal amount of \$100,000, payable at maturity. It provides for annual payments of interest of \$12,000. E's basis in the equivalent fixed rate debt instrument is \$110,000. The sum of all amounts payable on the equivalent fixed rate debt instrument (other than payments of qualified stated interest) is \$100,000. Under §1.171-1, the amount of bond premium is \$10,000 (\$110,000-\$100,000).

(iii) *Bond premium allocable to each accrual period.* E allocates bond premium to the remaining accrual periods by reference to the payment schedule on the equivalent fixed rate debt instrument. Based on the payment schedule of the equivalent fixed rate debt instrument and E's basis in the bond, E's yield is 10.12 percent, compounded annually. The bond premium allocable to the accrual period ending on March 1, 2000, is the excess of the qualified stated interest allocable to the period for the equivalent fixed rate debt instrument (\$12,000) over the product of the adjusted acquisition price at the beginning of the period (\$110,000) and E's yield (10.12 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is \$870.71 (\$12,000-\$11,129.29). The bond premium allocable to all the accrual periods is listed in the following schedule:

Accrual period ending	Adjusted acquisition price at beginning of accrual period	Premium allocable to accrual period
3/1/00	\$110,000.00	\$870.71
3/1/01	109,129.29	958.81
3/1/02	108,170.48	1,055.82
3/1/03	107,114.66	1,162.64
3/1/04	105,952.02	1,280.27
3/1/05	104,671.75	1,409.80
3/1/06	103,261.95	1,552.44
3/1/07	101,709.51	<u>1,709.51</u>
		\$10,000.00

(iv) *Qualified stated interest for each accrual period.* Assume the bond actually pays the following amounts of qualified stated interest:

Accrual period ending	Qualified stated interest
3/1/00	\$2,000.00
3/1/01	0.00
3/1/02	0.00
3/1/03	10,000.00
3/1/04	8,000.00
3/1/05	12,000.00
3/1/06	15,000.00
3/1/07	8,500.00

(v) *Premium used to offset interest.* E's interest income for each accrual period is determined by offsetting the qualified stated interest allocable to the period with the bond premium allocable to the period. For the accrual period ending on March 1, 2000, E includes in income \$1,129.29, the qualified stated interest allocable to the period (\$2,000) offset with the bond premium allocable to the period (\$870.71). For the accrual period ending on March 1, 2001, the bond premium allocable to the accrual period (\$958.81) exceeds the qualified stated interest allocable to the period (\$0) and, therefore, E does

not have interest income for this accrual period. However, under §1.171-2(a)(4)(i)(A), E may deduct as bond premium \$958.81, the excess of the bond premium allocable to the accrual period (\$958.81) over the qualified stated interest allocable to the accrual period (\$0). For the accrual period ending on March 1, 2002, the bond premium allocable to the accrual period (\$1,055.82) exceeds the qualified stated interest allocable to the accrual period (\$0) and, therefore, E does not have interest income for the accrual period. Under §1.171-2(a)(4)(i)(A), E's deduction for bond premium for the accrual period

is limited to \$170.48, the excess of E's total interest inclusions on the bond in prior accrual periods (\$1,129.29) over the total amount treated by E as a bond premium deduction in prior accrual periods

(\$958.81). Under §1.171-2(a)(4)(i)(B), E must carry forward the remaining \$885.34 of bond premium allocable to the period ending March 1, 2002, and treat it as bond premium allocable to the period

ending March 1, 2003. The amount E includes in income for each accrual period is shown in the following schedule:

<i>Accrual period ending</i>	<i>Qualified stated interest</i>	<i>Premium allocable to accrual period</i>	<i>Interest income</i>	<i>Premium deduction</i>	<i>Premium carryforward</i>
3/1/00	\$2,000.00	\$870.71	\$1,129.29		
3/1/01	0.00	958.81	0.00	\$958.81	
3/1/02	0.00	1,055.82	0.00	170.48	\$885.34
3/1/03	10,000.00	1,162.64	7,951.93		
3/1/04	8,000.00	1,280.27	6,719.73		
3/1/05	12,000.00	1,409.80	10,590.20		
3/1/06	15,000.00	1,552.44	13,447.56		
3/1/07	8,500.00	<u>1,709.51</u>	6,790.49		
		\$10,000.00			

Example 2. Partial call that results in a pro-rata prepayment—(i) Facts. On April 1, 1999, M purchases for \$110,000 N's taxable bond maturing on April 1, 2006, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest of \$10,000, payable on April 1 of each year. N has the option to call all or part of the bond on April 1, 2001, at a 5 percent premium over the principal amount. M uses the cash receipts and disbursements method of accounting.

(ii) *Determination of yield and the remaining payment schedule.* M's yield determined without regard to the call option is 8.07 percent, compounded annually. M's yield determined by assuming N exercises its call option is 6.89 percent, compounded annually. Under paragraph (c)(4)(ii)(A) of this section, it is assumed N will not exercise the call option because exercising the option would minimize M's yield. Thus, for purposes of determining and amortizing bond premium, the bond is assumed to be a seven-year bond with a single principal payment at maturity of \$100,000.

(iii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is \$100,000. Under §1.171-1, the amount of bond premium is \$10,000 (\$110,000-\$100,000).

(iv) *Bond premium allocable to the first two accrual periods.* For the accrual period ending on April 1, 2000, M includes in income \$8,881.83, the qualified stated interest allocable to the period (\$10,000) offset with bond premium allocable to the period (\$1,118.17). The adjusted acquisition price on April 1, 2000, is \$108,881.83 (\$110,000-\$1,118.17). For the accrual period ending on April 1, 2001, M includes in income \$8,791.54, the qualified stated interest allocable to the period (\$10,000) offset with bond premium allocable to the period (\$1,208.46). The adjusted acquisition price on April 1, 2001, is \$107,673.37 (\$108,881.83-\$1,208.46).

(v) *Partial call.* Assume N calls one-half of M's bond for \$52,500 on April 1, 2001. Because it was assumed the call would not be exercised, the call is a change in circumstances. However, the partial call is also a pro-rata prepayment within the meaning of §1.1275-2(f)(2). As a result, the call is treated as a retirement of one-half of the bond. Under paragraph

(c)(5)(ii) of this section, M may deduct \$1,336.68, the excess of its adjusted acquisition price in the retired portion of the bond (\$107,673.37/2, or \$53,836.68) over the amount received on redemption (\$52,500). M's adjusted basis in the portion of the bond that remains outstanding is \$53,836.68 (\$107,673.37-\$53,836.68).

§1.171-4 Election to amortize bond premium on taxable bonds.

(a) *Time and manner of making the election—(1) In general.* A holder makes the election to amortize bond premium by offsetting interest income with bond premium in the holder's timely filed federal income tax return for the first taxable year to which the holder desires the election to apply. The holder should attach to the return a statement that the holder is making the election under this section.

(2) *Coordination with OID election.* If a holder makes an election under §1.1272-3 for a bond with bond premium, the holder is deemed to have made the election under this section.

(b) *Scope of election.* The election under this section applies to all taxable bonds held during or after the taxable year for which the election is made.

(c) *Election to amortize made in a subsequent taxable year—(1) In general.* If a holder elects to amortize bond premium and holds a taxable bond acquired before the taxable year for which the election is made, the holder may not amortize amounts that would have been amortized in prior taxable years had an election been in effect for those prior years.

(2) *Example.* The following example illustrates the rule of this paragraph (c):

Example—(i) Facts. On May 1, 1999, C purchases for \$130,000 a taxable bond maturing on

May 1, 2006, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest of \$15,000, payable on May 1 of each year. C uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year. C has not previously elected to amortize bond premium, but does so for 2002.

(ii) *Amount to amortize.* C's basis for determining loss on the sale or exchange of the bond is \$130,000. Thus, under §1.171-1, the amount of bond premium is \$30,000. Under §1.171-2, if a bond premium election were in effect for the prior taxable years, C would have amortized \$3,257.44 of bond premium on May 1, 2000, and \$3,551.68 of bond premium on May 1, 2001, based on annual accrual periods ending on May 1. Thus, for 2002 and future years to which the election applies, C may amortize only \$23,190.88 (\$30,000-\$3,257.44-\$3,551.68).

(d) *Revocation of election.* The election under this section may not be revoked unless approved by the Commissioner. Because a revocation of the election is a change in accounting method, a taxpayer must follow the rules under §1.446-1(e)(3)(i) to request the Commissioner's consent to revoke the election. A revocation of the election applies to all taxable bonds held during or after the taxable year for which the revocation is effective. The holder may not amortize any remaining bond premium on bonds held at the beginning of the taxable year for which the revocation is effective. Therefore, no adjustment under section 481 is allowed upon the revocation of the election because no items of income or deduction are omitted or duplicated.

Par. 5. Section 1.171-5 is added to read as follows:

§1.171-5 Effective date and transition rules.

(a) *Effective date—(1) In general.* Sec-

tions 1.171-1 through 1.171-4 apply to bonds acquired on or after March 2, 1998. However, if a holder makes the election under §1.171-4 for the taxable year containing March 2, 1998, or any subsequent taxable year, §§1.171-1 through 1.171-4 apply to bonds held on or after the first day of the taxable year in which the election is made.

(2) *Transition rule for use of constant yield.* Notwithstanding paragraph (a)(1) of this section, §1.171-2(a)(3) (providing that the bond premium allocable to an accrual period is determined with reference to a constant yield) does not apply to a bond issued before September 28, 1985.

(b) *Coordination with existing election.* A holder is deemed to have made the election under §1.171-4 for the taxable year containing March 2, 1998, if the holder elected to amortize bond premium under section 171 and that election is effective on March 2, 1998. If the holder is deemed to have made the election under §1.171-4 for the taxable year containing March 2, 1998, §§1.171-1 through 1.171-4 apply to bonds acquired on or after the first day of that taxable year. See §1.171-4(d) for rules relating to a revocation of an election under section 171.

(c) *Accounting method changes—(1) Consent to change.* A holder required to change its method of accounting for bond premium to comply with §§1.171-1 through 1.171-3 must secure the consent of the Commissioner in accordance with the requirements of §1.446-1(e). Paragraph (c)(2) of this section provides the Commissioner's automatic consent for certain changes. A holder making the election under §1.171-4 does not need the Commissioner's consent to make the election.

(2) *Automatic consent.* The Commissioner grants consent for a holder to change its method of accounting for bond premium with respect to taxable bonds to which §§1.171-1 through 1.171-3 apply. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (c)(2) applies provided—

(i) The holder elected to amortize bond premium under section 171 for a taxable year prior to the taxable year containing March 2, 1998, and that election has not been revoked;

(ii) The change is made for the first taxable year for which the holder must account for a bond under §§1.171-1 through 1.171-3; and

(iii) The holder attaches to its return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

Par. 6. Section 1.249-1 is amended by revising paragraph (c) and the first sentence of paragraph (d)(2) to read as follows:

§1.249-1 Limitation on deduction of bond premium on repurchase.

* * * * *

(c) *Repurchase premium.* For purposes of this section, the term *repurchase premium* means the excess of the repurchase price paid or incurred to repurchase the obligation over its adjusted issue price (within the meaning of §1.1275-1(b)) as of the repurchase date. For the general rules applicable to the deductibility of repurchase premium, see §1.163-7(c). This paragraph (c) applies to convertible obligations repurchased on or after March 2, 1998.

(d) * * *

(2) * * * For a convertible obligation repurchased on or after March 2, 1998, a call premium specified in dollars under the terms of the obligation is considered to be a normal call premium on a nonconvertible obligation if the call premium applicable when the obligation is repurchased does not exceed an amount equal to the interest (including original issue discount) that otherwise would be deductible for the taxable year of repurchase (determined as if the obligation were not repurchased). * * *

* * * * *

Par. 7. Section 1.1016-5 is amended by revising paragraph (b) to read as follows:

§1.1016-5 Miscellaneous adjustments to basis.

* * * * *

(b) *Amortizable bond premium—(1) In general.* A holder's basis in a bond is reduced by the amount of bond premium used to offset qualified stated interest income under §1.171-2. This reduction occurs when the holder takes the qualified

stated interest into account under the holder's regular method of accounting.

(2) *Special rules for taxable bonds.* A holder's basis in a taxable bond is reduced by the amount of bond premium allowed as a deduction under §1.171-3(c)(5)(ii) (relating to the issuer's call of a taxable bond) or under §1.171-2(a)(4)(i)(A) (relating to excess bond premium).

(3) *Special rule for tax-exempt obligations.* A holder's basis in a tax-exempt obligation is reduced by the amount of excess bond premium that is treated as a nondeductible loss under §1.171-2(a)(4)(ii).

* * * * *

§1.1016-9 [Removed]

Par. 8. Section 1.1016-9 is removed.

Par. 9. Section 1.1275-1 is amended by:

- 1. Redesignating paragraph (b)(2) as paragraph (b)(3).
- 2. Adding a new paragraph (b)(2).

The addition reads as follows:

§1.1275-1 Definitions.

* * * * *

(b) * * *

(2) *Bond issuance premium.* If a debt instrument is issued with bond issuance premium (as defined in §1.163-13(c)), for purposes of determining the issuer's adjusted issue price, the adjusted issue price determined under paragraph (b)(1) of this section is also decreased by the amount of bond issuance premium previously allocable under §1.163-13(d)(3).

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 10. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 11. Section 602.101, paragraph (c) is amended by:

- 1. Removing the following entry from the table:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.171-3	1545-0172
* * * * *	

2. Adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.163-13	1545-1491
* * * * *	
1.171-4	1545-1491
1.171-5	1545-1491
* * * * *	

Michael P. Dolan,
*Deputy Commissioner of
Internal Revenue.*

Approved December 15, 1997.

Donald C. Lubick,
*Acting Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on December 30, 1997, 8:45 a.m., and published in the issue of the Federal Register for December 31, 1997, 62 F.R. 68173)