Sec. 1271. Treatment of amounts received on retirement or sale or exchange of debt instruments

(a) General rule
For purposes of this title--

(1) Retirement

   Amounts received by the holder on retirement of any debt instruments shall be considered as amounts received in exchange therefor.

(2) Ordinary income on sale or exchange where intention to call before maturity

   (A) In general [Reg. 1.1271-1]
   If at the time of original issue there was an intention to call a debt instrument before maturity, any gain realized on the sale or exchange thereof which does not exceed an amount equal to--

   (i) the original issue discount, reduced by

   (ii) the portion of original issue discount previously includible in the gross income of any holder (without regard to subsection (a)(7) or (b)(4) of section 1272 (or the corresponding provisions of prior law)), shall be treated as ordinary income.

   (B) Exceptions
   This paragraph (and paragraph (2) of subsection (c)) shall not apply to--

   (i) any tax-exempt obligation, or

   (ii) any holder who has purchased the debt instrument at a premium.

(3) Certain short-term Government obligations

   (A) In general [Reg. 1.1271-1(b)]
   On the sale or exchange of any short-term Government obligation, any gain
realized which does not exceed an amount equal to the ratable share of the acquisition discount shall be treated as ordinary income.

(B) Short-term Government obligation
   For purposes of this paragraph, the term "short-term Government obligation" means any obligation of the United States or any of its possessions, or of a State or any political subdivision thereof, or of the District of Columbia, which has a fixed maturity date not more than 1 year from the date of issue. Such term does not include any tax-exempt obligation.

(C) Acquisition discount
   For purposes of this paragraph, the term "acquisition discount" means the excess of the stated redemption price at maturity over the taxpayer's basis for the obligation.

(D) Ratable share
   For purposes of this paragraph, except as provided in subparagraph (E), the ratable share of the acquisition discount is an amount which bears the same ratio to such discount as--
   (i) the number of days which the taxpayer held the obligation, bears to
   (ii) the number of days after the date the taxpayer acquired the obligation and up to (and including) the date of its maturity.

(E) Election of accrual on basis of constant interest rate
   At the election of the taxpayer with respect to any obligation, the ratable share of the acquisition discount is the portion of the acquisition discount accruing while the taxpayer held the obligation determined (under regulations prescribed by the Secretary) on the basis of--
   (i) the taxpayer's yield to maturity based on the taxpayer's cost of acquiring the obligation, and
   (ii) compounding daily.

   An election under this subparagraph, once made with respect to any obligation, shall be irrevocable.

(4) Certain short-term nongovernment obligations

(A) In general [Reg. 1.1271-1(b)]
   On the sale or exchange of any short-term nongovernment obligation, any gain realized which does not exceed an amount equal to the ratable share of the original issue discount shall be treated as ordinary income.

(B) Short-term nongovernment obligation
For purposes of this paragraph, the term "short-term nongovernment obligation" means any obligation which--

(i) has a fixed maturity date not more than 1 year from the date of the issue, and

(ii) is not a short-term Government obligation (as defined in paragraph (3)(B) without regard to the last sentence thereof).

(C) Ratable share
For purposes of this paragraph, except as provided in subparagraph (D), the ratable share of the original issue discount is an amount which bears the same ratio to such discount as--

(i) the number of days which the taxpayer held the obligation, bears to

(ii) the number of days after the date of original issue and up to (and including) the date of its maturity.

(D) Election of accrual on basis of constant interest rate
At the election of the taxpayer with respect to any obligation, the ratable share of the original issue discount is the portion of the original issue discount accruing while the taxpayer held the obligation determined (under regulations prescribed by the Secretary) on the basis of--

(i) the yield to maturity based on the issue price of the obligation, and

(ii) compounding daily.

Any election under this subparagraph, once made with respect to any obligation, shall be irrevocable.

(b) EXCEPTION FOR CERTAIN OBLIGATIONS-

(1) IN GENERAL-
This section shall not apply to--

(A) any obligation issued by a natural person before June 9, 1997, and

(B) any obligation issued before July 2, 1982, by an issuer which is not a corporation and is not a government or political subdivision thereof.

(2) TERMINATION-
Paragraph (1) shall not apply to any obligation purchased (within the meaning of section 1272(d)(1)) after June 8, 1997.

(c) Transition rules
(1) Special rule for certain obligations issued before January 1, 1955
Paragraph (1) of subsection (a) shall apply to a debt instrument issued before January 1, 1955, only if such instrument was issued with interest coupons or in registered form, or was in such form on March 1, 1954.

(2) Special rule for certain obligations with respect to which original issue discount not currently includible

(A) In general

On the sale or exchange of debt instruments issued by a government or political subdivision thereof after December 31, 1954, and before July 2, 1982, or by a corporation after December 31, 1954, and on or before May 27, 1969, any gain realized which does not exceed--

(i) an amount equal to the original issue discount, or

(ii) if at the time of original issue there was no intention to call the debt instrument before maturity, [then] an amount which bears the same ratio to the original issue discount as the number of complete months that the debt instrument was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity, shall be considered as ordinary income.

(B) Subsection (a)(2)(A) not to apply

Subsection (a)(2)(A) shall not apply to any debt instrument referred to in subparagraph (A) of this paragraph.

(C) Cross reference

For current inclusion of original issue discount, see section 1272.

(d) Double inclusion in income not required

This section and sections 1272 shall not require the inclusion of any amount previously includible in gross income.

Sec. 1272. Current inclusion in income of original issue discount

(a) Original issue discount on debt instruments issued after July 1, 1982, included in income on basis of constant interest rate

(1) General rule [Reg. 1.1272-1]

For purposes of this title, there shall be included in the gross income of the holder of any debt instrument having original issue discount issued after July 1, 1982, an amount equal to the sum of the daily portions of the original issue
discount for each day during the taxable year on which such holder held such
debt instrument.

(2) Exceptions [Reg. 1.1272-1(a)(2)]

Paragraph (1) shall not apply to--

(A) Tax-exempt obligations
   Any tax-exempt obligation.

(B) United States savings bonds
   Any United States savings bond.

(C) Short-term obligations
   Any debt instrument which has a fixed maturity date not more than 1 year from
   the date of issue.

(D) Obligations issued by natural persons before March 2, 1984
   Any obligation issued by a natural person before March 2, 1984.

(E) Loans between natural persons

   (i) In general
   Any loan made by a natural person to another natural person if--

      (I) such loan is not made in the course of a trade or business of the
         lender, and

      (II) the amount of such loan (when increased by the outstanding
           amount of prior loans by such natural person to such other natural per-
           son) does not exceed $10,000.

   (ii) Clause (i) not to apply where tax avoidance a principal purpose
      Clause (i) shall not apply if the loan has as 1 of its principal purposes the
      avoidance of any Federal tax.

   (iii) Treatment of husband and wife
      For purposes of this subparagraph, a husband and wife shall be treated
      as 1 person. The preceding sentence shall not apply where the spouses
      lived apart at all times during the taxable year in which the loan is made.

(3) Determination of daily portions [Reg. 1.1272-1(b)]

For purposes of paragraph (1), the daily portion of the original issue discount on
any debt instrument shall be determined by allocating to each day in any accrual
period its ratable portion of the increase during such accrual period in the ad-
justed issue price of the debt instrument. For purposes of the preceding sen-
tence, the increase in the adjusted issue price for any accrual period shall be an
amount equal to the excess (if any) of--
(A) the product of--

(i) the adjusted issue price of the debt instrument at the beginning of such accrual period, and

(ii) the yield to maturity (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period), over

(B) the sum of the amounts payable as interest on such debt instrument during such accrual period.

(4) Adjusted issue price
For purposes of this subsection, the adjusted issue price of any debt instrument at the beginning of any accrual period is the sum of--

(A) the issue price of such debt instrument, plus

(B) the adjustments under this subsection to such issue price for all periods before the first day of such accrual period.

(5) Accrual period
Except as otherwise provided in regulations prescribed by the Secretary, the term "accrual period" means a 6-month period (or shorter period from the date of original issue of the debt instrument) which ends on a day in the calendar year corresponding to the maturity date of the debt instrument or the date 6 months before such maturity date.

(6) Determination of daily portions where principal subject to acceleration

(A) In general
In the case of any debt instrument to which this paragraph applies, the daily portion of the original issue discount shall be determined by allocating to each day in any accrual period its ratable portion of the excess (if any) of--

(i) the sum of

(I) the present value determined under subparagraph (B) of all remaining payments under the debt instrument as of the close of such period, and

(II) the payments during the accrual period of amounts included in the stated redemption price of the debt instrument, over

(ii) the adjusted issue price of such debt instrument at the beginning of such period.
(B) Determination of present value
For purposes of subparagraph (A), the present value shall be determined on the basis of--

(i) the original yield to maturity (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period),

(ii) events which have occurred before the close of the accrual period, and

(iii) a prepayment assumption determined in the manner prescribed by regulations.

(C) Debt instruments to which paragraph applies
This paragraph applies to--

(i) any regular interest in a REMIC or qualified mortgage held by a REMIC,

(ii) any other debt instrument if payments under such debt instrument may be accelerated by reason of prepayments of other obligations securing such debt instrument (or, to the extent provided in regulations, by reason of other events), or

(iii) any pool of debt instruments the yield on which may be affected by reason of prepayments (or to the extent provided in regulations, by reason of other events).

To the extent provided in regulations prescribed by the Secretary, in the case of a small business engaged in the trade or business of selling tangible personal property at retail, clause (iii) shall not apply to debt instruments incurred in the ordinary course of such trade or business while held by such business.

(7) Reduction where subsequent holder pays acquisition premium

(A) Reduction
For purposes of this subsection, in the case of any purchase after its original issue of a debt instrument to which this subsection applies, the daily portion for any day shall be reduced by an amount equal to the amount which would be the daily portion for such day (without regard to this paragraph) multiplied by the fraction determined under subparagraph (B).

(B) Determination of fraction
For purposes of subparagraph (A), the fraction determined under this subparagraph is a fraction--

(i) the numerator of which is the excess (if any) of--

(I) the cost of such debt instrument incurred by the purchaser, over
the issue price of such debt instrument, increased by the portion of original issue discount previously includible in the gross income of any holder (computed without regard to this paragraph), and

(ii) the denominator of which is the sum of the daily portions for such debt instrument for all days after the date of such purchase and ending on the stated maturity date (computed without regard to this paragraph).

(b) Ratable inclusion retained for corporate debt instruments issued before July 2, 1982

(1) General rule
There shall be included in the gross income of the holder of any debt instrument issued by a corporation after May 27, 1969, and before July 2, 1982--

(A) the ratable monthly portion of original issue discount, multiplied by

(B) the number of complete months (plus any fractional part of a month determined under paragraph (3)) such holder held such debt instrument during the taxable year.

(2) Determination of ratable monthly portion
Except as provided in paragraph (4), the ratable monthly portion of original issue discount shall equal--

(A) the original issue discount, divided by

(B) the number of complete months from the date of original issue to the stated maturity date of the debt instrument.

(3) Month defined
For purposes of this subsection--

(A) Complete month
A complete month commences with the date of original issue and the corresponding day of each succeeding calendar month (or the last day of a calendar month in which there is no corresponding day).

(B) Transfers during month
In any case where a debt instrument is acquired on any day other than a day determined under subparagraph (A), the ratable monthly portion of original issue discount for the complete month (or partial month) in which such acquisition occurs shall be allocated between the transferor and the transferee in accordance with the number of days in such complete (or partial) month each held the debt instrument.

(4) Reduction where subsequent holder pays acquisition premium
(A) Reduction
For purposes of this subsection, the ratable monthly portion of original issue
discount shall not include its share of the acquisition premium.

(B) Share of acquisition premium
For purposes of subparagraph (A), any month’s share of the acquisition pre-
mium is an amount (determined at the time of the purchase) equal to--

(i) the excess of--

(I) the cost of such debt instrument incurred by the holder, over
(II) the issue price of such debt instrument, increased by the portion of
original issue discount previously includible in the gross income of any holder
(computed without regard to this paragraph),

(ii) divided by the number of complete months (plus any fractional part of a
month) from the date of such purchase to the stated maturity date of such debt
instrument.

(c) Exceptions
This section shall not apply to any holder--

(1) who has purchased the debt instrument at a premium [see reg. section 1.1272-2], or

(2) which is a life insurance company to which section 811(b) applies.

(d) Definition and special rule

(1) Purchase defined
For purposes of this section, the term "purchase" means--

(A) any acquisition of a debt instrument, where

(B) the basis of the debt instrument is not determined in whole or in part by reference
to the adjusted basis of such debt instrument in the hands of the person from whom
acquired.

(2) Basis adjustment [Reg. 1.1272-1(g)]
The basis of any debt instrument in the hands of the holder thereof shall be
increased by the amount included in his gross income pursuant to this section.
Sec. 1273. Determination of amount of original issue discount

(a) General rule [Reg. 1.1273-1]
For purposes of this subpart--

(1) In general
The term "original issue discount" means the excess (if any) of--

(A) the stated redemption price at maturity, over

(B) the issue price.

(2) Stated redemption price at maturity [Reg. 1.1273-1(b)]
The term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument).

(3) 1/4 of 1 percent de minimis rule [Reg. 1.1273-1(d)]
If the original issue discount determined under paragraph (1) is less than--

(A) 1/4 of 1 percent of the stated redemption price at maturity, multiplied by

(B) the number of complete years to maturity,
then the original issue discount shall be treated as zero.

(b) Issue price [Reg. 1.1273-2]
For purposes of this subpart--

(1) Publicly offered debt instruments not issued for property
In the case of any issue of debt instruments--

(A) publicly offered, and

(B) not issued for property, the issue price is the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such debt instruments was sold.

(2) Other debt instruments not issued for property
In the case of any issue of debt instruments
(i) not issued for property and

(ii) not publicly offered,
the issue price of each such instrument is the price paid by the first buyer of such debt instrument.

(3) Debt instruments issued for property where there is public trading
In the case of a debt instrument which is issued for property and which--

(A) is part of an issue a portion of which is traded on an established securities market [Reg. 1.1273-2(b)], or

(B)

(i) is issued for stock or securities which are traded on an established securities market, or

(ii) to the extent provided in regulations, is issued for property (other than stock or securities) of a kind regularly traded on an established market [Reg. 1.1273-2(c)],
the issue price of such debt instrument shall be the fair market value of such property.

(4) Other cases [Reg. 1.1273-2(d)]
Except in any case--

(A) to which paragraph (1), (2), or (3) of this subsection applies, or

(B) to which section 1274 applies,
the issue price of a debt instrument which is issued for property shall be the stated redemption price at maturity.

(5) Property
In applying this subsection, the term "property" includes services and the right to use property, but such term does not include money.

(c) Special rules for applying subsection (b)
For purposes of subsection (b)--

(1) Initial offering price; price paid by the first buyer
The terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof.

(2) Treatment of investment units [Reg. 1.1273-2(h)]
In the case of any debt instrument and an option, security, or other property issued
together as an investment unit--

(A) the issue price for such unit shall be determined in accordance with the rules of this subsection and subsection (b) as if it were a debt instrument,

(B) the issue price determined for such unit shall be allocated to each element of such unit on the basis of the relationship of the fair market value of such element to the fair market value of all elements in such unit, and

(C) the issue price of any debt instrument included in such unit shall be the portion of the issue price of the unit allocated to the debt instrument under subparagraph (B).

Sec. 1274. Determination of issue price in the case of certain debt instruments issued for property

(a) In general [Reg. 1.1274-1]
In the case of any debt instrument to which this section applies, for purposes of this subpart, the issue price shall be--

(1) where there is adequate stated interest, the stated principal amount, or

(2) in any other case, the imputed principal amount.

(b) Imputed principal amount [Reg. 1.1274-1(c)]
For purposes of this section--

(1) In general
Except as provided in paragraph (3), the imputed principal amount of any debt instrument shall be equal to the sum of the present values of all payments due under such debt instrument.

(2) Determination of present value
For purposes of paragraph (1), the present value of a payment shall be determined in the manner provided by regulations prescribed by the Secretary--

(A) as of the date of the sale or exchange, and

(B) by using a discount rate equal to the applicable Federal rate, compounded semiannually.

(3) Fair market value rule in potentially abusive situations [Reg. 1.1274-3]

(A) In general
In the case of any potentially abusive situation, the imputed principal amount of any debt instrument received in exchange for property shall be the fair market value of such property adjusted to take into account other
consideration involved in the transaction.

(B) Potentially abusive situation defined
For purposes of subparagraph (A), the term "potentially abusive situation" means-

(i) a tax shelter (as defined in section 6662(d)(2)(C)(iii)), and

(ii) any other situation which, by reason of--

(I) recent sales transactions,

(II) nonrecourse financing,

(III) financing with a term in excess of the economic life of the property, or

(IV) other circumstances,
is of a type which the Secretary specifies by regulations as having potential for tax avoidance.

(c) Debt instruments to which section applies [Reg. 1.1274-1(a)]

(1) In general
Except as otherwise provided in this subsection, this section shall apply to any
debt instrument given in consideration for the sale or exchange of property if--

(A) the stated redemption price at maturity for such debt instrument exceeds--

(i) where there is adequate stated interest, the stated principal amount, or

(ii) in any other case, the imputed principal amount of such debt instru-
ment determined under subsection (b), and

(B) some or all of the payments due under such debt instrument are due more
than 6 months after the date of such sale or exchange.

(2) Adequate stated interest
For purposes of this section, there is adequate stated interest with respect to
any debt instrument if the stated principal amount for such debt instrument is
less than or equal to the imputed principal amount of such debt instrument de-
termined under subsection (b).

(3) Exceptions [Reg. 1.1274-1(b)]
This section shall not apply to--

(A) Sales for $1,000,000 or less of farms by individuals or small businesses
(i) In general
Any debt instrument arising from the sale or exchange of a farm (within the meaning of section 6420(c)(2))--

(1) by an individual, estate, or testamentary trust,

(2) by a corporation which as of the date of the sale or exchange is a small business corporation (as defined in section 1244(c)(3)), or

(3) by a partnership which as of the date of the sale or exchange meets requirements similar to those of section 1244(c)(3).

(ii) $1,000,000 limitation
Clause (i) shall apply only if it can be determined at the time of the sale or exchange that the sales price cannot exceed $1,000,000. For purposes of the preceding sentence, all sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange.

(B) Sales of principal residences
Any debt instrument arising from the sale or exchange by an individual of his principal residence (within the meaning of section 121).

(C) Sales involving total payments of $250,000 or less

(i) In general
Any debt instrument arising from the sale or exchange of property if the sum of the following amounts does not exceed $250,000:

(1) the aggregate amount of the payments due under such debt instrument and all other debt instruments received as consideration for the sale or exchange, and

(2) the aggregate amount of any other consideration to be received for the sale or exchange.

(ii) Consideration other than debt instrument taken into account at fair market value
For purposes of clause (i), any consideration (other than a debt instrument) shall be taken into account at its fair market value.

(iii) Aggregation of transactions
For purposes of this subparagraph, all sales and exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange.
(D) Debt instruments which are publicly traded or issued for publicly traded property

Any debt instrument to which section 1273(b)(3) [relating to debt instruments issued for property where there is public trading] applies.

(E) Certain sales of patents

In the case of any transfer described in section 1235(a) (relating to sale or exchange of patents), any amount contingent on the productivity, use, or disposition of the property transferred.

(F) Sales or exchanges to which section 483(e) applies

Any debt instrument to the extent section 483(e) (relating to certain land transfers between related persons) applies to such instrument.

(4) Exception for assumptions [Reg. 1.1274-5]

If any person--

(A) in connection with the sale or exchange of property, assumes any debt instrument, or

(B) acquires any property subject to any debt instrument,

in determining whether this section or section 483 applies to such debt instrument, such assumption (or such acquisition) shall not be taken into account unless the terms and conditions of such debt instrument are modified (or the nature of the transaction is changed) in connection with the assumption (or acquisition).

(d) Determination of applicable Federal rate [Reg. 1.1274-4]

For purposes of this section--

(1) Applicable Federal rate

(A) In general

In the case of a debt instrument with a term of:

The applicable Federal rate is:

Not over 3 years................. The Federal short-term rate.
Over 3 years but not over 9 years.. The Federal mid-term rate.
Over 9 years......................... The Federal long-term rate.

(B) Determination of rates

During each calendar month, the Secretary shall determine the Federal short-term rate, mid-term rate, and long-term rate which shall apply during the following calendar month.
(C) Federal rate for any calendar month
   For purposes of this paragraph--

   (i) Federal short-term rate
       The Federal short-term rate shall be the rate determined by the Secretary based
       on the average market yield (during any 1-month period selected by the Secre-
       tary and ending in the calendar month in which the determination is made) on
       outstanding marketable obligations of the United States with remaining periods
       to maturity of 3 years or less.

   (ii) Federal mid-term and long-term rates
       The Federal mid-term and long-term rate shall be determined in accordance
       with the principles of clause (i).

(D) Lower rate permitted in certain cases
   The Secretary may by regulations permit a rate to be used with respect to any
   debt instrument which is lower than the applicable Federal rate if the taxpayer
   establishes to the satisfaction of the Secretary that such lower rate is based on
   the same principles as the applicable Federal rate and is appropriate for the
   term of such instrument.

(2) Lowest 3-month rate applicable to any sale or exchange

   (A) In general
       In the case of any sale or exchange, the applicable Federal rate shall be
       the lowest 3-month rate.

   (B) Lowest 3-month rate
       For purposes of subparagraph (A), the term "lowest 3-month rate" means
       the lowest of the applicable Federal rates in effect for any month in the 3-
       calendar-month period ending with the 1st calendar month in which there
       is a binding contract in writing for such sale or exchange.

(3) Term of debt instrument
   In determining the term of a debt instrument for purposes of this subsection,
   under regulations prescribed by the Secretary, there shall be taken into
   account options to renew or extend.

(e) 110 Percent rate where sale-leaseback involved [Reg. 1.1274-4(a)(2)]

   (1) In general
       In the case of any debt instrument to which this subsection applies, the discount
       rate used under subsection (b)(2)(B) or section 483(b) shall be 110 percent of the
       applicable Federal rate, compounded semiannually.

   (2) Lower discount rates shall not apply
       Section 1274A shall not apply to any debt instrument to which this subsection

(3) Debt instruments to which this subsection applies

This subsection shall apply to any debt instrument given in consideration for the sale or exchange of any property if, pursuant to a plan, the transferor or any related person leases a portion of such property after such sale or exchange.

Sec. 1274A. Special rules for certain transactions where stated principal amount does not exceed $2,800,000

(a) Lower discount rate [Reg. 1.1274a-1]

In the case of any qualified debt instrument, the discount rate used for purposes of sections 483 and 1274 shall not exceed 9 percent, compounded semiannually.

(b) Qualified debt instrument defined

For purposes of this section, the term "qualified debt instrument" means any debt instrument given in consideration for the sale or exchange of property (other than new section 38 property within the meaning of section 48(b), as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) if the stated principal amount of such instrument does not exceed $2,800,000.

(c) Election to use cash method where stated principal amount does not exceed $2,000,000

(1) In general

In the case of any cash method debt instrument--

(A) section 1274 shall not apply, and

(B) interest on such debt instrument shall be taken into account by both the borrower and the lender under the cash receipts and disbursements method of accounting.

(2) Cash method debt instrument [Reg. 1.1274a-1(c)]

For purposes of paragraph (1), the term "cash method debt instrument" means any qualified debt instrument if--

(A) the stated principal amount does not exceed $2,000,000,

(B) the lender does not use an accrual method of accounting and is not a dealer with respect to the property sold or exchanged,

(C) section 1274 would have applied to such instrument but for an election under this subsection, and
(D) an election under this subsection is jointly made with respect to such debt instrument by the borrower and lender.

(3) Successors bound by election

(A) In general

Except as provided in subparagraph (B), paragraph (1) shall apply to any successor to the borrower or lender with respect to a cash method debt instrument.

(B) Exception where lender transfers debt instrument to accrual method taxpayer

If the lender (or any successor) transfers any cash method debt instrument to a taxpayer who uses an accrual method of accounting, this paragraph shall not apply with respect to such instrument for periods after such transfer.

(4) Fair market value rule in potentially abusive situations

In the case of any cash method debt instrument, section 483 shall be applied as if it included provisions similar to the provisions of section 1274(b)(3).

(d) Other special rules [Reg. 1.1274a-1(b)(3)]

(1) Aggregation rules

For purposes of this section--

(A) all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as 1 sale or exchange, and

(B) all debt instruments arising from the same transaction (or a series of related transactions) shall be treated as 1 debt instrument.

(2) Inflation adjustments [Reg. 1.1274a-1(b)(4)]

(A) In general

In the case of any debt instrument arising out of a sale or exchange during any calendar year after 1989, each dollar amount contained in the preceding provisions of this section shall be increased by the inflation adjustment for such calendar year. Any increase under the preceding sentence shall be rounded to the nearest multiple of $100 (or, if such increase is a multiple of $50, such increase shall be increased to the nearest multiple of $100).

(B) Inflation adjustment

For purposes of subparagraph (A), the inflation adjustment for any calendar year is the percentage (if any) by which--

(i) the CPI for the preceding calendar year exceeds

(ii) the CPI for calendar year 1988.
For purposes of the preceding sentence, the CPI for any calendar year is the average of the Consumer Price Index as of the close of the 12-month period ending on September 30 of such calendar year.

(e) Regulations
The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subsection, including--

(1) regulations coordinating the provisions of this section with other provisions of this title,

(2) regulations necessary to prevent the avoidance of tax through the abuse of the provisions of subsection (c), and

(3) regulations relating to the treatment of transfers of cash method debt instruments.

Sec. 1275. Other definitions and special rules

(a) Definitions [Reg. 1.1275-1]
For purposes of this subpart--

(1) Debt instrument [Reg. 1.1275-1(d)]

(A) In general
Except as provided in subparagraph (B), the term "debt instrument" means a bond, debenture, note, or certificate or other evidence of indebtedness.

(B) Exception for certain annuity contracts
The term "debt instrument" shall not include any annuity contract to which section 72 applies and which--

(i) depends (in whole or in substantial part) on the life expectancy of 1 or more individuals, or

(ii) is issued by an insurance company subject to tax under subchapter L-

(I) in a transaction in which there is no consideration other than cash or another annuity contract meeting the requirements of this clause,

(II) pursuant to the exercise of an election under an insurance contract by a beneficiary thereof on the death of the insured party under such contract, or

(III) in a transaction involving a qualified pension or employee benefit plan.
(2) Issue date

(A) Publicly offered debt instruments
In the case of any debt instrument which is publicly offered, the term "date of original issue" means the date on which the issue was first issued to the public.

(B) Issues not publicly offered and not issued for property
In the case of any debt instrument to which section 1273(b)(2) applies, the term "date of original issue" means the date on which the debt instrument was sold by the issuer.

(C) Other debt instruments
In the case of any debt instrument not described in subparagraph (A) or (B), the term "date of original issue" means the date on which the debt instrument was issued in a sale or exchange.

(3) Tax-exempt obligation
The term "tax-exempt obligation" means any obligation if--

(A) the interest on such obligation is not includible in gross income under section 103, or

(B) the interest on such obligation is exempt from tax (without regard to the identity of the holder) under any other provision of law. [Reg. 1.1275-1(e)]

(4) Treatment of obligations distributed by corporations
Any debt obligation of a corporation distributed by such corporation with respect to its stock shall be treated as if it had been issued by such corporation for property.

(b) Treatment of borrower in the case of certain loans for personal use

(1) Sections 1274 and 483 not to apply
In the case of the obligor under any debt instrument given in consideration for the sale or exchange of property, sections 1274 and 483 shall not apply if such property is personal use property.

(2) Original issue discount deducted on cash basis in certain cases
In the case of any debt instrument, if--

(A) such instrument--

(i) is incurred in connection with the acquisition or carrying of personal use property, and

(ii) has original issue discount (determined after the application of paragraph (1)), and
(B) the obligor under such instrument uses the cash receipts and disbursements method of accounting,

notwithstanding section 163(e), the original issue discount on such instrument shall be deductible only when paid.

(3) Personal use property
For purposes of this subsection, the term "personal use property" means any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in section 212. The determination of whether property is described in the preceding sentence shall be made as of the time of issuance of the debt instrument.

(c) Information requirements [Reg. 1.1275-3]

(1) Information required to be set forth on instrument

(A) In general
In the case of any debt instrument having original issue discount, the Secretary may by regulations require that--

(i) the amount of the original issue discount, and

(ii) the issue date,

be set forth on such instrument.

(B) Special rule for instruments not publicly offered
In the case of any issue of debt instruments not publicly offered, the regulations prescribed under subparagraph (A) shall not require the information to be set forth on the debt instrument before any disposition of such instrument by the first buyer.

(2) Information required to be submitted to Secretary
In the case of any issue of publicly offered debt instruments having original issue discount, the issuer shall (at such time and in such manner as the Secretary shall by regulation prescribe) furnish the Secretary the following information:

(A) The amount of the original issue discount.

(B) The issue date.

(C) Such other information with respect to the issue as the Secretary may by regulations require.

For purposes of the preceding sentence, any person who makes a public offering of
stripped bonds (or stripped coupons) shall be treated as the issuer of a publicly offered
debt instrument having original issue discount.

(3) Exceptions
This subsection shall not apply to any obligation referred to in section 1272(a)(2)
(relating to exceptions from current inclusion of original issue discount).

(4) Cross reference
For civil penalty for failure to meet requirements of this subsection, see section 6706.

(d) Regulation authority  [Reg. 1.1275-2(g)]
The Secretary may prescribe regulations providing that where, by reason of varying rates of
interest  [Reg. 1.1275-5], put or call options, indefinite maturities, contingent payments  [Reg.
1.1275-4], assumptions of debt instruments, or other circumstances, the tax treatment under
this subpart (or section 163(e)) does not carry out the purposes of this subpart (or section
163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes
of this subpart (or section 163(e)).

Subpart B -- Market discount on bonds

Sec. 1276. Disposition gain representing accrued market
discount treated as ordinary income

(a) Ordinary income

(1) In general
Except as otherwise provided in this section, gain on the disposition of any
market discount bond shall be treated as ordinary income to the extent it does
not exceed the accrued market discount on such bond. Such gain shall be rec-
ognized notwithstanding any other provision of this subtitle.

(2) Dispositions other than sales, etc.
For purposes of paragraph (1), a person disposing of any market discount bond
in any transaction other than a sale, exchange, or involuntary conversion shall
be treated as realizing an amount equal to the fair market value of the bond.

(3) Treatment of partial principal payments

(A) In general
Any partial principal payment on a market discount bond shall be included
in gross income as ordinary income to the extent such payment does not
exceed the accrued market discount on such bond.

(B) Adjustment
If subparagraph (A) applies to any partial principal payment on any market discount bond, for purposes of applying this section to any disposition of (or subsequent partial principal payment on) such bond, the amount of accrued market discount shall be reduced by the amount of such partial principal payment included in gross income under subparagraph (A).

(4) Gain treated as interest for certain purposes

Except for purposes of sections 103, 871(a), 881, 1441, 1442, and 6049 (and such other provisions as may be specified in regulations), any amount treated as ordinary income under paragraph (1) or (3) shall be treated as interest for purposes of this title.

(b) Accrued market discount

For purposes of this section--

(1) Ratable accrual

Except as otherwise provided in this subsection or subsection (c), the accrued market discount on any bond shall be an amount which bears the same ratio to the market discount on such bond as--

(A) the number of days which the taxpayer held the bond, bears to

(B) the number of days after the date the taxpayer acquired the bond and up to (and including) the date of its maturity.

(2) Election of accrual on basis of constant interest rate (in lieu of ratable accrual)

(A) In general

At the election of the taxpayer with respect to any bond, the accrued market discount on such bond shall be the aggregate amount which would have been includible in the gross income of the taxpayer under section 1272(a) (determined without regard to paragraph (2) thereof) with respect to such bond for all periods during which the bond was held by the taxpayer if such bond had been-

(i) originally issued on the date on which such bond was acquired by the taxpayer,

(ii) for an issue price equal to the basis of the taxpayer in such bond immediately after its acquisition.

(B) Coordination where bond has original issue discount

In the case of any bond having original issue discount, for purposes of applying subparagraph (A)--

(i) the stated redemption price at maturity of such bond shall be treated as equal to its revised issue price, and
(ii) the determination of the portion of the original issue discount which would have been includible in the gross income of the taxpayer under section 1272(a) shall be made under regulations prescribed by the Secretary.

(C) Election irrevocable
An election under subparagraph (A), once made with respect to any bond, shall be irrevocable.

(3) Special rule where partial principal payments
In the case of a bond the principal of which may be paid in 2 or more payments, the amount of accrued market discount shall be determined under regulations prescribed by the Secretary.

(c) Treatment of nonrecognition transactions
Under regulations prescribed by the Secretary--

(1) Transferred basis property
If a market discount bond is transferred in a nonrecognition transaction and such bond is transferred basis property in the hands of the transferee, for purposes of determining the amount of the accrued market discount with respect to the transferee--

(A) the transferee shall be treated as having acquired the bond on the date on which it was acquired by the transferor for an amount equal to the basis of the transferor, and

(B) proper adjustments shall be made for gain recognized by the transferor on such transfer (and for any original issue discount or market discount included in the gross income of the transferor).

(2) Exchanged basis property
If any market discount bond is disposed of by the taxpayer in a nonrecognition transaction and paragraph (1) does not apply to such transaction, any accrued market discount determined with respect to the property disposed of to the extent not theretofore treated as ordinary income under subsection (a)--

(A) shall be treated as accrued market discount with respect to the exchanged basis property received by the taxpayer in such transaction if such property is a market discount bond, and

(B) shall be treated as ordinary income on the disposition of the exchanged basis property received by the taxpayer in such exchange if such property is not a market discount bond.

(3) Paragraph (1) to apply to certain distributions by corporations or partnerships
For purposes of paragraph (1), if the basis of any market discount bond in the
hands of a transferee is determined under section 732(a), or 732(b) , such property shall be treated as transferred basis property in the hands of such transferee.

(d) Special rules

Under regulations prescribed by the Secretary--

(1) rules similar to the rules of subsection (b) of section 1245 shall apply for purposes of this section; except that--

(A) paragraph (1) of such subsection shall not apply,

(B) an exchange qualifying under section 354(a), 355(a), or 356(a) (determined without regard to subsection (a) of this section) shall be treated as an exchange described in paragraph (3) of such subsection, and

(C) paragraph (3) of section 1245(b) shall be applied as if it did not contain a reference to section 351, and

(2) appropriate adjustments shall be made to the basis of any property to reflect gain recognized under subsection (a).

Sec. 1277. Deferral of interest deduction allocable to accrued market discount

(a) General rule

Except as otherwise provided in this section, the net direct interest expense with respect to any market discount bond shall be allowed as a deduction for the taxable year only to the extent that such expense exceeds the portion of the market discount allocable to the days during the taxable year on which such bond was held by the taxpayer (as determined under the rules of section 1276(b)).

(b) Disallowed deduction allowed for later years

(1) Election to take into account in later year where net interest income from bond

(A) In general

If--

(i) there is net interest income for any taxable year with respect to any market discount bond, and

(ii) the taxpayer makes an election under this subparagraph with respect to such bond,
any disallowed interest expense with respect to such bond shall be treated as interest paid or accrued by the taxpayer during such taxable year to the extent such disallowed interest expense does not exceed the net interest income with respect to such bond.

(B) Determination of disallowed interest expense
For purposes of subparagraph (A), the amount of the disallowed interest expense--

(i) shall be determined as of the close of the preceding taxable year, and

(ii) shall not include any amount previously taken into account under subparagraph (A).

(C) Net interest income
For purposes of this paragraph, the term "net interest income" means the excess of the amount determined under paragraph (2) of subsection (c) over the amount determined under paragraph (1) of subsection (c).

(2) Remainder of disallowed interest expense allowed for year of disposition

(A) In general
Except as otherwise provided in this paragraph, the amount of the disallowed interest expense with respect to any market discount bond shall be treated as interest paid or accrued by the taxpayer in the taxable year in which such bond is disposed of.

(B) Nonrecognition transactions
If any market discount bond is disposed of in a nonrecognition transaction--

(i) the disallowed interest expense with respect to such bond shall be treated as interest paid or accrued in the year of disposition only to the extent of the amount of gain recognized on such disposition, and

(ii) the disallowed interest expense with respect to such property (to the extent not so treated) shall be treated as disallowed interest expense--

(I) in the case of a transaction described in section 1276(c)(1), of the transferee with respect to the transferred basis property, or

(II) in the case of a transaction described in section 1276(c)(2), with respect to the exchanged basis property.

(C) Disallowed interest expense reduced for amounts previously taken into account under paragraph (1)
For purposes of this paragraph, the amount of the disallowed interest expense
shall not include any amount previously taken into account under paragraph (1).

(3) Disallowed interest expense
For purposes of this subsection, the term "disallowed interest expense" means the aggregate amount disallowed under subsection (a) with respect to the market discount bond.

(c) Net direct interest expense
For purposes of this section, the term "net direct interest expense" means, with respect to any market discount bond, the excess (if any) of--

(1) the amount of interest paid or accrued during the taxable year on indebtedness which is incurred or continued to purchase or carry such bond, over

(2) the aggregate amount of interest (including original issue discount) includible in gross income for the taxable year with respect to such bond.

In the case of any financial institution which is a bank (as defined in section 585(a)(2)), the determination of whether interest is described in paragraph (1) shall be made under principles similar to the principles of section 291(e)(1)(B)(ii). Under rules similar to the rules of section 265(a)(5), short sale expenses shall be treated as interest for purposes of determining net direct interest expense.

Sec. 1278. Definitions and special rules

(a) In general
For purposes of this part--

(1) Market discount bond

   (A) In general
   Except as provided in subparagraph (B), the term "market discount bond" means any bond having market discount.

   (B) Exceptions
   The term "market discount bond" shall not include--

   (i) Short-term obligations
   Any obligation with a fixed maturity date not exceeding 1 year from the date of issue.

   (ii) United States savings bonds
   Any United States savings bond.

   (iii) Installment obligations
Any installment obligation to which section 453B applies.

(C) Section 1277 not applicable to tax-exempt obligations. --
For purposes of section 1277, the term "market discount bond" shall not include any tax-exempt obligation (as defined in section 1275(a)(3)).

(D) Treatment of bonds acquired at original issue

(i) In general
Except as otherwise provided in this subparagraph or in regulations, the term "market discount bond" shall not include any bond acquired by the taxpayer at its original issue.

(ii) Treatment of bonds acquired for less than issue price
Clause (i) shall not apply to any bond if--

(I) the basis of the taxpayer in such bond is determined under section 1012, and

(II) such basis is less than the issue price of such bond determined under subpart A of this part.

(iii) Bonds acquired in certain reorganizations
Clause (i) shall not apply to any bond issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1)) in exchange for another bond having market discount. Solely for purposes of section 1276, the preceding sentence shall not apply if such other bond was issued on or before July 18, 1984 (the date of the enactment of section 1276) and if the bond issued pursuant to such plan of reorganization has the same term and the same interest rate as such other bond had.

(iv) Treatment of certain transferred basis property
For purposes of clause (i), if the adjusted basis of any bond in the hands of the taxpayer is determined by reference to the adjusted basis of such bond in the hands of a person who acquired such bond at its original issue, [then] such bond shall be treated as acquired by the taxpayer at its original issue.

(2) Market discount

(A) In general
The term "market discount" means the excess (if any) of--

(i) the stated redemption price of the bond at maturity, over

(ii) the basis of such bond immediately after its acquisition by the taxpayer.
(B) Coordination where bond has original issue discount
In the case of any bond having original issue discount, for purposes of subparagraph (A), the stated redemption price of such bond at maturity shall be treated as equal to its revised issue price.

(C) De minimis rule
If the market discount is less than 1/4 of 1 percent of the stated redemption price of the bond at maturity multiplied by the number of complete years to maturity (after the taxpayer acquired the bond), then the market discount shall be considered to be zero.

(3) Bond
The term "bond" means any bond, debenture, note, certificate, or other evidence of indebtedness.

(4) Revised issue price
The term "revised issue price" means the sum of--

(A) the issue price of the bond, and

(B) the aggregate amount of the original issue discount includible in the gross income of all holders for periods before the acquisition of the bond by the taxpayer (determined without regard to section 1272(a)(7) or (b)(4)) or, in the case of a tax-exempt obligation, the aggregate amount of the original issue discount which accrued in the manner provided by section 1272(a) (determined without regard to paragraph (7) thereof) during periods before the acquisition of the bond by the taxpayer.

(5) Original issue discount, etc.
The terms "original issue discount", "stated redemption price at maturity", and "issue price" have the respective meanings given such terms by subpart A of this part.

(b) Election to include market discount currently

(1) In general
If the taxpayer makes an election under this subsection--

(A) sections 1276 [providing that disposition gain representing accrued market discount is treated as ordinary income] and 1277 shall not apply, and

(B) market discount on any market discount bond shall be included in the gross income of the taxpayer for the taxable years to which it is attributable (as determined under the rules of subsection (b) of section 1276).

Except for purposes of sections 103, 871(a), 881, 1441, 1442, and 6049 (and such other provisions as may be specified in regulations), any amount included in gross income under subparagraph (B) shall be treated as interest for purposes of this
(2) Scope of election
An election under this subsection shall apply to all market discount bonds acquired by the taxpayer on or after the 1st day of the 1st taxable year to which such election applies.

(3) Period to which election applies
An election under this subsection shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

(4) Basis adjustment
The basis of any bond in the hands of the taxpayer shall be increased by the amount included in gross income pursuant to this subsection.

(c) Regulations
The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subpart, including regulations providing proper adjustments in the case of a bond the principal of which may be paid in 2 or more payments.

Subpart C -- Discount on short-term obligations

Sec. 1281. Current inclusion in income of discount on certain short-term obligations

(a) General rule
In the case of any short-term obligation to which this section applies, for purposes of this title-

(1) there shall be included in the gross income of the holder an amount equal to the sum of the daily portions of the acquisition discount for each day during the taxable year on which such holder held such obligation, and

(2) any interest payable on the obligation (other than interest taken into account in determining the amount of the acquisition discount) shall be included in gross income as it accrues.

(b) Short-term obligations to which section applies

(1) In general
This section shall apply to any short-term obligation which--

(A) is held by a taxpayer using an accrual method of accounting,

(B) is held primarily for sale to customers in the ordinary course of the taxpayer's trade or business,

(C) is held by a bank (as defined in section 581),

(D) is held by a regulated investment company or a common trust fund,

(E) is identified by the taxpayer under section 1256(e)(2) as being part of a hedging transaction, or

(F) is a stripped bond or stripped coupon held by the person who stripped the bond or coupon (or by any other person whose basis is determined by reference to the basis in the hands of such person).

(2) Treatment of obligations held by pass-thru entities

(A) In general

This section shall apply also to--

(i) any short-term obligation which is held by a pass-thru entity which is formed or availed of for purposes of avoiding the provisions of this section, and

(ii) any short-term obligation which is acquired by a pass-thru entity (not described in clause (i)) during the required accrual period.

(B) Required accrual period

For purposes of subparagraph (A), the term "required accrual period" means the period--

(i) which begins with the first taxable year for which the ownership test of subparagraph (C) is met with respect to the pass-thru entity (or a predecessor), and

(ii) which ends with the first taxable year after the taxable year referred to in clause (i) for which the ownership test of subparagraph (C) is not met and with respect to which the Secretary consents to the termination of the required accrual period.

(C) Ownership test

The ownership test of this subparagraph is met for any taxable year if, on at least 90 days during the taxable year, 20 percent or more of the value of the interests in the pass-thru entity are held by persons described in paragraph (1) or by other pass-thru entities to which subparagraph (A) applies.
(D) Pass-thru entity
The term "pass-thru entity" means any partnership, S corporation, trust, or other pass-thru entity.

(c) Cross reference
For special rules limiting the application of this section to original issue discount in the case of nongovernmental obligations, see section 1283(c).

Sec. 1282. Deferral of interest deduction allocable to accrued discount

(a) General rule
Except as otherwise provided in this section, the net direct interest expense with respect to any short-term obligation shall be allowed as a deduction for the taxable year only to the extent such expense exceeds the sum of--

(1) the daily portions of the acquisition discount for each day during the taxable year on which the taxpayer held such obligation, and

(2) the amount of any interest payable on the obligation (other than interest taken into account in determining the amount of the acquisition discount) which accrues during the taxable year while the taxpayer held such obligation (and is not included in the gross income of the taxpayer for such taxable year by reason of the taxpayer's method of accounting).

(b) Section not to apply to obligations to which section 1281 applies

(1) In general
This section shall not apply to any short-term obligation to which section 1281 applies.

(2) Election to have section 1281 apply to all obligations

A) In general
A taxpayer may make an election under this paragraph to have section 1281 apply to all short-term obligations acquired by the taxpayer on or after the 1st day of the 1st taxable year to which such election applies.

(B) Period to which election applies
An election under this paragraph shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

(c) Certain rules made applicable
Rules similar to the rules of subsections (b) [disallowed deduction allowed for later years] and (c) of section 1277 shall apply for purposes of this section.

(d) Cross reference
For special rules limiting the application of this section to original issue discount in the case of nongovernmental obligations, see section 1283(c).

Sec. 1283. Definitions and special rules

(a) Definitions
For purposes of this subpart --

(1) Short-term obligation

(A) In general
Except as provided in subparagraph (B), the term "short-term obligation" means any bond, debenture, note, certificate, or other evidence of indebtedness which has a fixed maturity date not more than 1 year from the date of issue.

(B) Exceptions for tax-exempt obligations
The term "short-term obligation" shall not include any tax-exempt obligation (as defined in section 1275(a)(3)).

(2) Acquisition discount
The term "acquisition discount" means the excess of--

(A) the stated redemption price at maturity (as defined in section 1273), over

(B) the taxpayer's basis for the obligation.

(b) Daily portion
For purposes of this subpart--

(1) Ratable accrual
Except as otherwise provided in this subsection, the daily portion of the acquisition discount is an amount equal to--

(A) the amount of such discount, divided by

(B) the number of days after the day on which the taxpayer acquired the obligation and up to (and including) the day of its maturity.

(2) Election of accrual on basis of constant interest rate (in lieu of ratable accrual)

(A) In general
At the election of the taxpayer with respect to any obligation, the daily portion of the acquisition discount for any day is the portion of the acquisition discount accruing on such day determined (under regulations prescribed by the Secretary) on the basis of--

(i) the taxpayer's yield to maturity based on the taxpayer's cost of acquiring the obligation, and
(ii) compounding daily.

(B) Election irrevocable
   An election under subparagraph (A), once made with respect to any obligation, shall be irrevocable.

(c) Special rules for nongovernmental obligations

(1) In general
   In the case of any short-term obligation which is not a short-term Government obligation (as defined in section 1271(a)(3)(B))--

   (A) sections 1281 and 1282 shall be applied by taking into account original issue discount in lieu of acquisition discount, and

   (B) appropriate adjustments shall be made in the application of subsection (b) of this section.

(2) Election to have paragraph (1) not apply

   (A) In general
      A taxpayer may make an election under this paragraph to have paragraph (1) not apply to all obligations acquired by the taxpayer on or after the first day of the first taxable year to which such election applies.

   (B) Period to which election applies
      An election under this paragraph shall apply to the taxable year for which it is made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of such election.

(d) Other special rules

(1) Basis adjustments
   The basis of any short-term obligation in the hands of the holder thereof shall be increased by the amount included in his gross income pursuant to section 1281.

(2) Double inclusion in income not required
   Section 1281 shall not require the inclusion of any amount previously includible in gross income.

(3) Coordination with other provisions
   Section 454(b) and paragraphs (3) and (4) of section 1271(a) shall not apply to any short-term obligation to which section 1281 applies.
Subpart D -- Miscellaneous provisions

Sec. 1286. Tax treatment of stripped bonds

(a) Inclusion in income as if bond and coupons were original issue discount bonds

If any person purchases after July 1, 1982, a stripped bond or a stripped coupon, then such bond or coupon while held by such purchaser (or by any other person whose basis is determined by reference to the basis in the hands of such purchaser) shall be treated for purposes of this part as a bond originally issued on the purchase date and having an original issue discount equal to the excess (if any) of--

(1) the stated redemption price at maturity (or, in the case of coupon, the amount payable on the due date of such coupon), over

(2) such bond's or coupon's ratable share of the purchase price.

For purposes of paragraph (2), ratable shares shall be determined on the basis of their respective fair market values on the date of purchase. [Reg. 1.1286-1]

(b) Tax treatment of person stripping bond

For purposes of this subtitle, if any person strips 1 or more coupons from a bond and after July 1, 1982, disposes of the bond or such coupon --

(1) such person shall include in gross income an amount equal to the sum of--

(A) the interest accrued on such bond while held by such person and before the time such coupon or bond was disposed of (to the extent such interest has not theretofore been included in such person’s gross income), and

(B) the accrued market discount on such bond determined as of the time such coupon or bond was disposed of (to the extent such discount has not theretofore been included in such person’s gross income),

(2) the basis of the bond and coupons shall be increased by the amount included in gross income under paragraph (1),

(3) the basis of the bond and coupons immediately before the disposition (as adjusted pursuant to paragraph (2)) shall be allocated among the items retained by such person and the items disposed of by such person on the basis of their respective fair market values, and

(4) for purposes of subsection (a), such person shall be treated as having purchased on the date of such disposition each such item which he retains for an amount equal to the basis allocated to such item under paragraph (3).
A rule similar to the rule of paragraph (4) shall apply in the case of any person whose basis in any bond or coupon is determined by reference to the basis of the person described in the preceding sentence.

(c) Retention of existing law for stripped bonds purchased before July 2, 1982
If a bond issued at any time with interest coupons--

(1) is purchased after August 16, 1954, and before January 1, 1958, and the purchaser does not receive all the coupons which first become payable more than 12 months after the date of the purchase, or

(2) is purchased after December 31, 1957, and before July 2, 1982, and the purchaser does not receive all the coupons which first become payable after the date of the purchase, the gain on the sale or other disposition of such bond by such purchaser (or by a person whose basis is determined by reference to the basis in the hands of such purchaser) shall be considered as ordinary income to the extent that the fair market value (determined as of the time of the purchase) of the bond with coupons attached exceeds the purchase price. If this subsection and section 1271(a)(2)(A) apply with respect to gain realized on the sale or exchange of any evidence of indebtedness, then section 1271(a)(2)(A) shall apply with respect to that part of the gain to which this subsection does not apply.

(d) Special rules for tax-exempt obligations

(1) In general
In the case of any tax-exempt obligation (as defined in section 1275(a)(3)) from which 1 or more coupons have been stripped--

(A) the amount of the original issue discount determined under subsection (a) with respect to any stripped bond or stripped coupon--

(i) shall be treated as original issue discount on a tax-exempt obligation to the extent such discount does not exceed the tax-exempt portion of such discount, and

(ii) shall be treated as original issue discount on an obligation which is not a tax-exempt obligation to the extent such discount exceeds the tax-exempt portion of such discount,

(B) subsection (b)(1)(A) shall not apply, and

(C) subsection (b)(2) shall be applied by increasing the basis of the bond or coupon by the sum of--

(i) the interest accrued but not paid before such bond or coupon was disposed of (and not previously reflected in basis), plus

(ii) the amount included in gross income under subsection (b)(1)(B).
(2) Tax-exempt portion
For purposes of paragraph (1), the tax-exempt portion of the original issue discount determined under subsection (a) is the excess of--

(A) the amount referred to in subsection (a)(1), over

(B) an issue price which would produce a yield to maturity as of the purchase date equal to the lower of--

(i) the coupon rate of interest on the obligation from which the coupons were separated, or

(ii) the yield to maturity (on the basis of the purchase price) of the stripped obligation or coupon.

The purchaser of any stripped obligation or coupon may elect to apply clause (i) by substituting "original yield to maturity of" for "coupon rate of interest on".

(e) Definitions and special rules
For purposes of this section--

(1) Bond
The term "bond" means a bond, debenture, note, or certificate or other evidence of indebtedness.

(2) Stripped bond
The term "stripped bond" means a bond issued at any time with interest coupons where there is a separation in ownership between the bond and any coupon which has not yet become payable.

(3) Stripped coupon
The term "stripped coupon" means any coupon relating to a stripped bond.

(4) Stated redemption price at maturity
The term "stated redemption price at maturity" has the meaning given such term by section 1273(a)(2).

(5) Coupon
The term "coupon" includes any right to receive interest on a bond (whether or not evidenced by a coupon). This paragraph shall apply for purposes of subsection (c) only in the case of purchases after July 1, 1982.

(6) Purchase
The term "purchase" has the meaning given such term by section 1272(d)(1).

(f) Regulation authority
The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, or other circumstances, the tax treatment under this section does not accurately reflect the income of the holder of a stripped coupon or stripped bond, or of the person disposing of such bond or coupon, as the case may be, for any period, such treatment shall be modified to require that the proper amount of income be included for such period.

Sec. 1287. Denial of capital gain treatment for gains on certain obligations not in registered form

(a) In general
If any registration-required obligation is not in registered form, any gain on the sale or other disposition of such obligation shall be treated as ordinary income (unless the issuance of such obligation was subject to tax under section 4701).

(b) Definitions
For purposes of subsection (a)--

(1) Registration-required obligation
The term "registration-required obligation" has the meaning given to such term by section 163(f)(2) except that clause (iv) of subparagraph (A), and subparagraph (B), of such section shall not apply.

(2) Registered form
The term "registered form" has the same meaning as when used in section 163(f).

Sec. 1288. Treatment of original issue discount on tax-exempt obligations

(a) General rule
Original issue discount on any tax-exempt obligation shall be treated as accruing--

(1) for purposes of section 163, in the manner provided by section 1272(a) (determined without regard to paragraph (7) thereof), and

(2) for purposes of determining the adjusted basis of the holder, in the manner provided by section 1272(a) (determined with regard to paragraph (7) thereof).

(b) Definitions and special rules
For purposes of this section--

(1) Original issue discount
The term "original issue discount" has the meaning given to such term by section 1273(a) without regard to paragraph (3) thereof. In applying section 483 or 1274, under regulations prescribed by the Secretary, appropriate adjustments shall be made to the applicable Federal rate to take into account the tax exemption for interest on the
obligation.

(2) Tax-exempt obligation
The term "tax-exempt obligation" has the meaning given to such term by section 1275(a)(3).

(3) Short-term obligations
In applying this section to obligations with maturity of 1 year or less, rules similar to the rules of section 1283(b) shall apply.