

AMERICAN JURISPRUDENCE

SECOND EDITION

VOLUME 33A (1994 Edition)

FEDERAL TAXATION ¶¶ 4000-17954

VOLUMES 33, 33A, 34, AND 34A CONTAIN A MODERN COMPREHENSIVE TEXTUAL STATEMENT OF THE FEDERAL TAX LAW. VOLUMES 33, 33A, AND 34 CONSIST OF MATERIAL FOUND IN THE 1994 EDITION OF THE TAX GUIDE PREPARED BY THE TAX EXPERTS ON THE STAFF OF THE RESEARCH INSTITUTE OF AMERICA, INC. VOLUME 34A CONSISTS OF MATERIAL DERIVED FROM THE ESTATE PLANNING & TAXATION COORDINATOR (EPTC) OF THE RESEARCH INSTITUTE OF AMERICA, INC.

1993



Lawyers Cooperative Publishing

Aqueduct Building, Rochester, New York 14694

on the income tax return.²⁰ The election is irrevocable with respect to the obligation for which it is made.²¹

¶ 12405. Nongovernment short-term obligations.

With respect to nongovernment short-term obligations, the mandatory accrual of discount (interest) rules are applied by taking into account the original issue discount (OID), rather than acquisition discount, on the obligation.²²

However, the holder of a nongovernment short-term obligation may elect to have the mandatory accrual rule apply (instead of the OID rules).²³ The election is effective for all obligations acquired by the taxpayer on or after the first day of the first tax year to which the election applies.²⁴ The election is available regardless of whether the obligation was acquired after originally issued.²⁵

The election applies for the tax year in which it is made, and to all later years unless it is revoked with

IRS consent.²⁶

The election must be made by the due date (including extensions) of the income tax return for the first tax year for which it is to apply,²⁷ by attaching a statement to that return. The statement must:

- ... contain taxpayer's name, address, and taxpayer identification number,
- ... identify the election,
- ... indicate the legal authority under which the election is made, i.e., Code Sec. 1283(c)(2),
- ... specify the period for which the election is being made and the obligations to which it is to apply, and
- ... provide sufficient information to show that the taxpayer is entitled to make the election.²⁸

No election may be made for a tax year if the period for claiming a credit or refund for that year has expired.²⁹

¶ 12450. Original Issue Discount (OID) as Taxable Interest.

The holder of a debt instrument issued with original issue discount (OID) must include part of the OID in income each year he holds the instrument.

✓ for in-depth discussion, see RIA's Federal Tax Coordinator 2d Chapter J, and RIA's Analysis of Federal Taxes: Income Chapter J.

¶ 12451. **Current inclusion of original issue discount as interest income.** The holder of a debt instrument specified at ¶ 12453 that is issued with OID must include part of that OID in his gross income, as interest, in each tax year that he holds the debt instrument even though the OID is not paid until maturity.¹

Observation: The current inclusion rules apply regardless of the method of accounting used by the holder.

The current inclusion of OID rule *does not apply* to the following holders:

- ... Holders of debt instruments issued before '85 that are not capital assets in the holder's hands.²
- ... A holder who purchases the debt instrument at a premium.³ Premium means a purchase price for an instrument that exceeds its stated redemption price at maturity (¶ 12455).⁴
- ... A holder whose basis in the debt instrument is determined by reference to its basis in the hands of a

person who purchased it at a premium.⁵ or

... A life insurance company required to accrue discount under the rules of Code Sec. 811(b).⁶

For the definition of debt instrument, see ¶ 12452.

For the definition of OID, see ¶ 12454 *et seq.*

For how to determine the amount of OID that must be included in gross income currently, see ¶ 12472 *et seq.*

For OID on stripped bonds and coupons, see ¶ 12476.

¶ 12452. **Debt instrument defined.** For OID purposes, the term "debt instrument" means a bond, debenture, note, or certificate or other evidence of indebtedness.⁷ However, debt instruments do not include certain annuity contracts to which Code Sec. 72 applies (¶ 12700 *et seq.*)⁸

The term "evidence of indebtedness" includes the following:

20. IRS Pub No. 550 (1992) p. 17.

21. Code Sec. 1283(b)(2)(B).

22. Code Sec. 1283(c)(1).

23. Code Sec. 1283(c)(2).

24. Code Sec. 1283(c)(2)(A).

25. Conf Rept No. 98-861 (PL 98-369) p. 809.

26. Code Sec. 1283(c)(2)(B).

27. Reg. § 301.9100-6T(a)(2)(i).

28. Reg. § 301.9100-6T(a)(3).

29. Reg. § 301.9100-6T(r).

1. Code Sec. 1272.

2. Sec. 44(g), PL 98-369, 7/18/84 as amend by Sec. 1803(b)(5), PL 99-514, 10/22/86.

3. Code Sec. 1272(c)(1).

4. Reg. § 1.1232-3(d)(2).

5. Reg. § 1.1232-3(d)(2).

6. Code Sec. 1272(c)(2).

7. Code Sec. 1275(a)(1)(A).

8. Code Sec. 1275(a)(1)(B).

... "Face amount certificate" as defined in Secs. 2(a)(15) and 4 of the Investment Company Act of 1940.⁹

... Certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions.¹⁰

... Participations in demand notes.¹¹

... Revolving fund credits.¹²

... Joint stock land bank bonds.¹³

¶ 12453. Debt instruments subject to current inclusion of OID rules. The OID current inclusion rules apply to all debt instruments (¶ 12452) issued with OID *other than the following*:

- (1) Tax-exempt obligations (¶ 13006*et seq.*).¹⁴
- (2) U.S. savings bonds (¶ 12158).¹⁵
- (3) Short-term obligations, i.e., obligations with a fixed maturity date not more than one year from the date of issue (¶ 12400 *et seq.*).¹⁶
- (4) Obligations issued by natural persons before Mar. 2, '84.¹⁷
- (5) Loans between natural persons if the amount of the loan plus the outstanding amount of earlier loans by the same creditor to the same debtor does not exceed \$10,000 *and* the loan is not made in the course of the lender's trade or business. This exception doesn't apply if the avoidance of any federal tax is one of the principal purposes of the loan.¹⁸

observation: The individual non-business loans of \$10,000 that qualify under (5), above, are excepted from the OID current inclusion rule even if the loan was made after the Mar. 1, '84 cut-off date in (4), above, for obligations issued by individuals.

(6) Debt instruments (other than corporate debt instruments) issued before July 2, '82.¹⁹

(7) Face amount certificates (as defined in Secs. 2(a)(15) and 4 of the Investment Company Act of '40) issued before '76.²⁰

(8) Corporate debt instruments issued before May 28, '69.²¹

IRS issues a list of publicly traded obligations for which current inclusion of OID is required.²² This list also includes certain Treasury bills.²³

Original Issue Discount (OID)

¶ 12454. Original issue discount defined. Original issue discount (OID) means the excess, if any, of the obligation's stated redemption price at maturity (¶ 12455) over its issue price (¶ 12456).²⁴

But the OID is treated as zero if that excess is less than:

... ¼ of 1% (0.25%) of the stated redemption price at maturity, multiplied by

... the number of complete years to maturity.²⁵

illustration: J buys a debt instrument that matures in 10 years from a corporation for an issue price of \$9,800. The stated redemption price at maturity is \$10,000 so that the excess of the stated redemption price at maturity over the issue price is \$200. ¼ of 1% of the stated redemption price at maturity is \$25. The product of \$25 multiplied by 10 (the number of complete years to maturity) is \$250. Since this is more than the \$200 excess, there is no OID on the instrument.

For special rules for determining OID on a price level adjusted mortgage (PLAM), see ¶ 12471.

¶ 12455. Stated redemption price at maturity defined. For OID purposes, a debt instrument's "stated redemption price at maturity" is the amount fixed by the last modification of the purchase agreement. It includes interest and other amounts payable at that time. But it does not include interest that is based on a fixed rate and that is payable unconditionally at fixed periodic intervals of one year or less during the entire term of the instrument.²⁶

illustration: T pays \$90,000 for a promissory note with a face amount of \$100,000. The note provides for payment of the face amount in three years and payment of interest unconditionally of \$10,000 at the end of the first year, \$10,000 at the end of the second year, and \$10,000 at the end of the third year (i.e., at the same time the face amount is paid). None of the interest payable at maturity is included in determining the stated redemption price at maturity since the interest is payable unconditionally at a fixed rate at yearly intervals. Thus, the stated redemption price at maturity is \$100,000.

If the interest payable at maturity exceeds the periodic fixed rate amount described above, then the excess is included in the stated redemption price at maturity. If interest payable at any time before maturity

9. Reg § 1.1232-1(c)(1).

10. Reg § 1.1232-1(d).

11. *Milliken, Seth*, (1950) 15 TC 243, *aff'd in part & rev'd in part on other issues* (1952, CA2) 196 F2d 135, *cert den* (1952, S Ct) 344 US 884, 97 L Ed 684, *reh den* (1952, S Ct) 344 US 910, 97 L Ed 702.

12. *Greenville Corp.*, (1963) 40 TC 926(A).

13. *Noll, William*, (1941) 43 BTA 496.

14. Code Sec. 1272(a)(2)(A).

15. Code Sec. 1272(a)(2)(B).

16. Code Sec. 1272(a)(2)(C).

17. Code Sec. 1272(a)(2)(D).

18. Code Sec. 1272(a)(2)(E).

19. Code Sec. 1272(a); Code Sec. 1272(b).

20. Reg § 1.1232-1(c)(3).

21. Code Sec. 1272(b).

22. IRS Pub No. 1212 (1992).

23. Ann 93-32, 1993-8 IRB 70.

24. Code Sec. 1273(a)(1).

25. Code Sec. 1273(a)(3).

26. Code Sec. 1273(a)(2).

exceeds this periodic fixed rate amount (if any) payable at that time, that excess is treated as the stated redemption price at maturity of a separate debt instrument.²⁷

Illustration: Same facts as in the above illustration except that the total interest payable is \$35,000, with \$15,000 of that payable at the end of the third year. The stated redemption price at maturity is \$105,000—\$100,000 face amount plus \$5,000, the difference between the interest actually paid at maturity (\$15,000) and the amount payable at a fixed rate at yearly intervals over the term of the instrument (\$10,000).

If an obligation is issued as part of an investment unit that includes an option, security, or other property, the obligation's stated redemption price at maturity is the amount payable, on maturity, in respect of the obligation. It does not include any amount payable in respect of the option, security or other property under a repurchase agreement or option to buy or sell the option, etc.²⁸

Issue Price

¶ 12456. **Issue price.** The issue price used in the OID calculation (¶ 12454) depends on whether the debt instrument was issued for money or property, and whether it is publicly traded (¶ 12457 *et seq.*). These rules apply even for a "new" debt instrument that is issued in a corporate reorganization in exchange for an outstanding debt instrument (¶ 12467).²⁹

For this purpose, property includes services and the right to use property, but does not include money.³⁰ Thus, it includes all tangible and intangible property except U.S. currency and checks.³¹

Also, a debt obligation distributed by a corporation with respect to its stock is treated as though it had been issued for property.³²

¶ 12457. **Publicly offered debt instrument issued for money.** The issue price of a publicly offered debt instrument issued for money is the initial offering price to the public (excluding bond houses and brokers) at which a substantial amount of the debt instruments is sold.³³

Ordinarily the issue price is the first price at which bonds are sold to the public. It includes the aggregate payments made by the buyer under the offering (including any modifications).³⁴ But it does not change if, due to market developments, part of the issue must be sold at a different price.³⁵

¶ 12458. **Privately offered debt instruments issued for money.** The issue price of a debt instrument that is not publicly offered, and that is issued for money, is the price paid by the first buyer of that instrument.³⁶

Accordingly, when debt instruments are privately placed, the issue price of each debt instrument includes the aggregate payments made under the purchase agreement (including modifications) by the first buyer of that particular debt instrument, irrespective of the issue price for the remainder of the issue.³⁷

● **Observation:** The term "first buyer" means the original issuee (or first holder) of a particular debt instrument, as distinct from a later buyer of that same debt instrument.

● **Illustration:** In Year 1, J and M each buy debt instruments with a face amount of \$10,000 from A corporation, the issuer of the debt instruments. The debt instruments are part of the same series of debt instruments, i.e., a series paying interest at a rate of 10% semi-annually and maturing on Jan. 1, year 20. J buys his debt instrument ten days before M and pays \$8,500 to A corporation for that debt instrument. M pays \$8,400 for her debt instrument. Both J and M are first buyers since each is the original issuee of the debt instrument he bought. Accordingly, the issue price of J's debt instrument is \$8,500 and the issue price of M's debt instrument is \$8,400.

The above rule also applies to determine the issue price of a "net worth note." This is a fixed principal amount debt instrument provided by the Resolution Trust Corporation, FDIC, or FSLIC as an integral part of the acquisition of the stock or assets of a financially troubled institution.³⁸

¶ 12459. **Debt instrument issued for property where there is public trading.** If a debt instrument is issued for property and: (1) the debt instrument is part of an issue a portion of which is traded on an established securities market,³⁹ (2) the property consists of stock or securities traded on an established securities market,⁴⁰ or (3) to the extent provided in regs, the debt instrument is issued for property (other than stock or securities) of a kind regularly traded on an established market,⁴¹ then the issue price of the instrument is the fair market value (FMV) of the property so traded.⁴²

The FMV of the property described in (1) is deemed to equal the FMV of the debt instrument, which is determined by reference to that part of the

27. Reg. § 1.1232-3(b)(1)(ii).

28. Reg. § 1.1232-3(b)(1)(iii).

29. Code Sec. 1273(b).

30. Code Sec. 1273(b)(5).

31. H. Rept. No. 98-432, Part 2 (PL. 98-369) p. 1246.

32. Code Sec. 1275(a)(4).

33. Code Sec. 1273(b)(1).

34. Code Sec. 1273(c)(1).

35. Reg. § 1.1232-3(b)(2)(i).

36. Code Sec. 1273(b)(2).

37. Code Sec. 1273(c)(1); Reg. § 1.1232-3(b)(2)(ii).

38. Notice 89-102, 1989-2 CB 436.

39. Code Sec. 1273(b)(3)(A).

40. Code Sec. 1273(b)(3)(B)(i).

41. Code Sec. 1273(b)(3)(B)(ii).

42. Code Sec. 1273(b)(3).

issue that is traded on an established securities market. This determination is made as of the first date after the date of issue when a debt instrument that is part of the issue is publicly traded.⁴³

Illustration: York Inc issues a debt instrument with a face value of \$10,000 to T on Apr. 1, Year 1, in exchange for 500 shares of Lancaster Ltd common stock, which is traded on an established securities market. The debt instrument is part of an issue that is traded on an established securities market. The first trade of a debt instrument of the same series occurs on Apr. 5, Year 1, when a \$1,000 face value instrument is traded for \$850. Accordingly, the FMV of the debt instrument issued to T is \$8,500. The FMV of the Lancaster common stock is also deemed to be \$8,500 regardless of the price the stock was actually trading for. It follows, that the issue price of the debt instrument is also \$8,500.

If the debt instrument is not part of an issue that is traded on an established securities market, but the property consists of stock or securities that are so traded, the FMV of the stock or securities (i.e., the property) is determined as of the date the debt instrument is issued, using the rules for determining the value of publicly traded stock in a decedent's estate without taking into account blockage and other special rules (¶ 41961).⁴⁴

¶ 12460. Nonpublicly traded debt instrument sold or exchanged for nonpublicly traded property.

If a nonpublicly traded debt instrument is sold or exchanged for nonpublicly traded property, the instrument's issue price is determined under the following rules:

(1) If some or all of the payments under the debt instrument are due more than six months after the sale or exchange, and if the stated redemption price at maturity (¶ 12455) exceeds either: (a) the stated principal amount of the debt instrument if there is adequate stated interest (¶ 12461), or (b) the imputed principal amount (¶ 12462) in any other case, then the issue price equals:⁴⁵

... the stated principal amount, if there is adequate stated interest;⁴⁶ or

... the imputed principal amount, if stated interest is not adequate.⁴⁷

(2) If none of the payments due under the debt instrument is due more than six months after the sale or exchange, or if the stated redemption price at maturity does not exceed (a) or (b), above, then the issue price

equals the stated redemption price at maturity.⁴⁸

Observation: The stated principal amount and the stated redemption price at maturity will not be the same if amounts other than the stated principal amount are included in determining the stated redemption price at maturity. For example, if interest is payable in excess of a fixed rate payable at intervals of a year or less, the excess is added to the stated principal amount to obtain the stated redemption price at maturity.

A nonpublicly traded debt instrument means a debt instrument that is not part of a series traded on an established securities market. Nonpublicly traded property means property that does not consist of stock or securities traded on an established securities market.⁴⁹

For exceptions to these rules, see ¶ 12466 *et seq.*

*For sales and exchanges before Jan. 1, '85, or under a binding contract in effect on Mar. 1, '84,*⁵⁰ the issue price of a nonpublicly traded debt instrument sold or exchanged for nonpublicly traded property is the debt instrument's stated redemption price at maturity.¹

¶ 12461. Adequate stated interest. There is adequate stated interest for a debt instrument if the stated principal amount for the instrument is less than or equal to its imputed principal amount (¶ 12462).² This means that the discount rate used to determine whether an instrument has adequate stated interest is the same as the rate used to determine its issue price.³

For sales or exchanges before July 1, '85, there is adequate stated interest on the instrument if its stated principal amount is less than or equal to a "testing amount."⁴ The testing amount is determined in the same way as the imputed principal amount except that these discount rates are used to determine the present values of all payments due under the debt instrument:

(1) For sales or exchanges of "new section 38 property" (i.e., new investment credit property), the discount rate is 110% of the applicable Federal rate (¶ 12464) compounded semiannually.⁵

(2) For sales or exchanges of property other than "new section 38 property" where the borrowed amount (i.e., the stated principal amount) was \$2,000,000 or less, a discount rate of 9% is used.⁶ If the borrowed amount exceeded \$2,000,000, the discount rate used is the sum of (a) 9% plus (b) the percentage determined by multiplying the excess of 110% of the applicable Federal rate over 9% by a fraction, the numerator of which is the excess of the

43. Reg. § 1.1232-3(b)(2)(iii).
 44. Reg. § 1.1232-3(b)(2)(iii).
 45. Code Sec. 1274(c)(1).
 46. Code Sec. 1274(c)(1).
 47. Code Sec. 1274(a)(2).
 48. Code Sec. 1273(b)(4).
 49. Reg. § 1.1232-3(b)(2)(iii).
 50. Sec. 44(b)(1), PL 98-369, 7/18/84.

1. Code Sec. 1273(b)(4).
 2. Code Sec. 1274(c)(2).
 3. H. Rept. No. 99-87 (PL 99-121) p. 13.
 4. Code Sec. 1274(c)(2) before amend by Sec. 101(a)(2)(c), PL 99-121, 10/11/85.
 5. Code Sec. 1274(c)(3) before amend by Sec. 101(a)(1)(d), PL 99-121, 10/11/85.
 6. Sec. 44(b)(4)(d), PL 98-369, 7/18/84 as added by Sec. 2, PL 98-612, 10/31/84 and amend by Sec. 1803(b)(1), PL 99-514, 10/22/86.

borrowed amount over \$2,000,000, and the denominator of which is the borrowed amount.⁷

¶ 12462. **Imputed principal amount.** Except for "potentially abusive situations" (¶ 12463), the imputed principal amount is the sum of the present values of all payments of principal and interest due under the debt instrument. These present values are computed as of the date of the sale or exchange by using the discount rates shown below, which are based on the applicable federal rate (AFR).⁸

Transaction	Discount rate
(1) Sale or exchange of property (other than "new section 38 property" and property part of which is leased back to the seller) where stated principal amount of debt instrument does not exceed a statutory dollar limitation. The limitation, which is adjusted for inflation, ²⁹ equals: \$3,234,900 for sales and exchanges in '92, ³⁰ \$3,079,600 for sales, etc., in '91, ³¹ \$2,933,200 for sales, etc., in '90, ³² and \$2,800,000 for sales, etc., before '90, ³³	Not more than 9% compounded semiannually.
(2) Sale or exchange of property (other than "new section 38 property" and property part of which is leased back to the seller) where stated principal amount of debt instrument is over the statutory dollar limitation in (1), above. ³⁴	100% of AFR compounded semiannually.
(3) Sale or exchange of "new section 38 property" (other than property part of which is leased back to the seller). ³⁵	100% of AFR compounded semiannually.
(4) Sale or exchange of property where part of property is leased back to seller or to a person related to the seller. ³⁶	110% of AFR compounded semiannually.

Transaction	Discount rate
(5) Sale or exchange before July 1, '85 of property (other than "new section 38 property") where borrowed amount (i.e., the stated principal amount) does not exceed \$2,000,000. ³⁷	10% compounded semiannually.
(6) Sale or exchange before July 1, '85 of property (other than "new section 38 property") where borrowed amount is over \$2,000,000 ³⁸	10%, plus the percentage determined by multiplying the excess of 120% of the AFR over 10% by a fraction, the numerator of which is the excess of the borrowed amount over \$2,000,000 and the denominator of which is the borrowed amount. The discount rate as so determined is compounded semiannually.
(7) Sale or exchange before July 1, '85 of "new section 38 property." ³⁹	120% of AFR compounded semiannually.
(8) Sale or exchange where taxpayer establishes to IRS's satisfaction, under regs to be issued, that a rate lower than the AFR should be used with respect to a debt instrument, and the lower rate is based on the same principles as the AFR ²¹	Lower rate established by taxpayer.

¶ 12463. **Imputed principal amount in potentially abusive situations.** The rules at ¶ 12462 don't apply to determine the imputed principal amount of a debt instrument received in exchange for

7. Sec. 44(b)(4)(a)(i), PL 98-369, 7/18/84 as added by Sec. 2, PL 98-612, 10/31/84 and amend by Sec. 1803(b)(1), PL 99-514, 10/22/86.

8. Code Sec. 1274(b)(2).

29. Code Sec. 1274(b); Code Sec. 1274A(d)(2).

30. Rev Rul 92-6, 1992-4 IRB 6.

31. Rev Rul 91-11, 1991-1 CB 183.

32. Rev Rul 90-68, 1990-2 CB 200.

33. Code Sec. 1274(b); Rev Rul 90-68, 1990-2 CB 200.

34. Code Sec. 1274A(a); Code Sec. 1274A(b).

35. Code Sec. 1274(b)(2)(B); Code Sec. 1274A(a); Code Sec. 1294A(b).

36. Code Sec. 1274(c).

37. Sec. 44(b)(4)(A)(ii), PL 98-369, 7/18/84; Sec. 44(b)(4)(C)(i), PL 98-369, 7/18/84 as added by Sec. 2, PL 98-612, 10/31/84 and amended by Sec. 1803(b)(1), PL 99-514, 10/22/86.

38. Sec. 44(A)(ii), PL 98-369, 7/18/84; Sec. 44(b)(4)(C), PL 98-369, 7/18/84 as added by Sec. 2, PL 98-612, 10/31/84 and amend by Sec. 1803(b)(1), PL 99-514, 10/22/86.

39. Code Sec. 1274(b)(2)(B) before amend by Sec. 101(a)(1)(A), PL 99-121, 10/11/85; Sec. 44(b)(4)(A)(ii), PL 98-369, 7/18/84 as added by Sec. 2, PL 98-612, 10/31/84.

21. Code Sec. 1274(d)(1)(B).

property where the exchange involves a "potentially abusive situation." The imputed principal amount of the debt instrument received in this case equals the fair market value of that property, adjusted to take into account other consideration involved in the transaction.²²

The term "potentially abusive situation" means:

(1) A tax shelter as defined in Code Sec. 6662(d)(2)(C)(ii) (for purposes of the penalty for substantial underpayment of tax (¶ 71629), i.e., not the "tax shelter" definition used in the tax shelter registration rules (¶ 71809));²³ or

(2) Any other situation which, by reason of recent sales transactions, nonrecourse financing, financing with a term in excess of the economic life of the property, or other circumstances, is of a type specified in regs as having a potential for tax avoidance.²⁴ This also applies to Code Sec. 483 transactions (deferred payment sales where interest is imputed, see ¶ 12550 *et seq.*).²⁵

¶ 12464. Determination of applicable federal rate. IRS determines the applicable short-term, mid-term, and long-term federal rates used in determining the issue price of a nonpublicly traded debt instrument sold or exchanged for nonpublicly traded property.²⁶ For applicable federal rate (AFR) charts, see ¶ 740.

The short-term AFR is used if the term of the instrument is three years or less. If the term is over three years but not over nine years, the mid-term rate is used. If the term is over nine years, the long-term rate is used.²⁷ Options to renew or extend the debt instrument are taken into account, as prescribed by regs, in determining the instrument's term for this purpose.²⁸

The AFR to be used on a sale or exchange is the lowest three-month rate.²⁹ This means the lowest of the AFRs in effect for any month in the three calendar-month period ending with the first calendar-month in which there is a binding written contract for the sale or exchange.³⁰

Illustration: On Mar. 15, '93, John enters into a binding contract to sell new investment credit property to a corporation in exchange for a nonpublicly traded debt instrument payable in three years. The applicable short-term federal rate for the month of Mar. '93 is 3.96%, for the month of Feb. '93 is 4.23%, and for the month of Jan. '93 is 4.37%. The discount rate used in determining the debt instrument's imputed principal amount is 100% of 3.96

(the Mar. '93 rate), since this is the lowest of the AFRs in effect for any month during the 3-calendar month period ending with Mar. '93.

¶ 12466. Sales or exchanges of nonpublicly traded property for nonpublicly traded debt instruments where issue price equals stated redemption price at maturity. For some transactions (see below) where nonpublicly traded debt instruments are sold or exchanged for nonpublicly traded property, the "regular" rules for determining issue price (¶ 12460 *et seq.*) do not apply. Instead, the instrument's issue price (for OID purposes) equals its stated redemption price at maturity (¶ 12455).³¹

Observation: This means there is no OID on debt instruments issued in these transactions. However, there may be unstated interest on these sales or exchanges under the rules discussed at ¶ 12550 *et seq.* (relating to deferred payment sales).

These transactions include:

(1) Sales or exchanges of property where the total payments due under the debt instrument and all other consideration (including other debt instruments received as consideration) for the transaction do not exceed \$250,000.³²

(2) Sales or exchanges by an individual of his principal residence (within the meaning of Code Sec. 1034, see ¶ 10650 *et seq.*).³³

(3) Sales or exchanges of certain farms by an individual, an estate, a testamentary trust, a small business corporation as defined in Code Sec. 1244 (¶ 10806) or a partnership (if it meets requirements similar to those of Code Sec. 1244(c)(3) for small business corporations), but only if at the time of the sale or exchange it can be determined that the sales price cannot exceed \$1,000,000.³⁴

(4) Amounts that are contingent on the production, use or disposition of property with respect to the transfer of a patent as described in Code Sec. 1235(a) (¶ 11053).³⁵

(5) Certain transfers of land between an individual and a member of that individual's family that are subject to the unstated interest rules of Code Sec. 483(e) (¶ 12556).³⁶

(6) Sales or exchanges after June 30, '85 where a cash method debt instrument is issued by the buyer in exchange for property. A "cash method debt instrument" is a debt instrument issued in exchange for property (other than "new section 38 property") if:

(a) The stated principal amount does not exceed a

22. Code Sec. 1274(b)(3)(A).

23. Code Sec. 1274(b)(3)(B)(i).

24. Code Sec. 1274(b)(3)(B)(ii).

25. Sec. 44(b)(3)(a)(ii), PL 98-369, 07/18/84as amend by Sec. 1803(b)(2), PL 99-

514, 10/22/86

26. Code Sec. 1274(d).

27. Code Sec. 1274(d)(1).

28. Code Sec. 1274(d)(3).

29. Code Sec. 1274(d)(2)(A).

30. Code Sec. 1274(d)(2)(B).

31. Code Sec. 1273(b)(4).

32. Code Sec. 1274(c)(3)(C).

33. Code Sec. 1274(c)(3)(B).

34. Code Sec. 1274(c)(3)(A).

35. Code Sec. 1274(c)(3)(E).

36. Code Sec. 1274(c)(3)(F).

specified dollar limit.³⁷ This dollar limit, which is adjusted for inflation (for sales, etc., after '89),³⁸ equals \$2,380,300 for sales and exchanges in '93,³⁹ \$2,310,600 for sales, etc., in '92,⁴⁰ \$2,199,700 for sales, etc., in '91, \$2,095,100 for sales, etc., in '90,⁴¹ and \$2,000,000 for sales, etc., before '90;

(b) The lender does not use an accrual method of accounting;

(c) The lender is not a dealer with respect to the property sold or exchanged;

(d) The "regular" Code Sec. 1274 issue price rules would otherwise have applied to the debt instrument; and

(e) An election to have the debt instrument treated as a cash method debt instrument is made jointly by the borrower and lender.⁴²

(7) Sales or exchanges before July 1, '85 and after Dec. 31, '84 of property (other than "new section 38 property") used in the business of farming if the borrowed amount doesn't exceed \$2,000,000.⁴³

¶ 12467. Debt instruments issued in corporate reorganizations. The "regular" issue price rules (¶ 12456 *et seq.*) are used to determine the issue price of a "new" debt instrument that, in a reorganization as defined in Code Sec. 368(a)(1) (¶ 5050 *et seq.*), is issued by a corporation in exchange either for its own stock or for its own already issued "old" debt instruments. This means that the issue price of the new debt instrument is determined under the rules that apply where a debt instrument is issued in exchange for property (¶ 12459).⁴⁴

Observation: This is because stock and debt instruments are considered property for this purpose.

Thus, even if a debt-for-debt exchange qualifies as a tax-free reorganization, OID (as well as cancellation of indebtedness (COD) income, see ¶ 12900 *et seq.*) still can be created where the exchange is a realization event under Code Sec. 1001 and the debt instrument's stated redemption price at maturity exceeds its issue price. However, this OID determination doesn't affect the amount of gain or loss recognized on the exchange under the reorganization provisions of Code Secs. 354, 355, or 356 (¶ 5050 *et seq.*).⁴⁵

For these purposes, the issue price of the "new" debt instrument is determined by reference to FMV if either the "new" or "old" debt instrument is publicly traded. If neither instrument is publicly traded, then

the "new" issue price is determined as follows: The issue price of a new debt instrument that has adequate stated interest (¶ 12461) is its stated principal amount. If it lacks adequate stated interest, the issue price is determined by using the AFR that is used in discounting the payments due under the instrument (¶ 12462).⁴⁶

The above rules apply not only to the issuer of the instrument, but also to its holder (creditor) (¶ 12472).⁴⁷

For debt instruments issued before Oct. 10, '90,⁴⁸ and those issued (a) in a title 11 or similar case filed before Oct. 10, '90,⁴⁹ (b) under a written binding contract in effect at all times after Oct. 8, '90,⁵⁰ (c) under a transaction described in documents filed with the SEC before Oct. 10, '90,¹ or (d) under a transaction the material terms of which were described in a public announcement before Oct. 10, '90, and which was the subject of an earlier SEC filing, and which is the subject of a later SEC filing before Jan. 1, '91,² OID on a debt-for-debt exchange in a corporate reorganization is determined as follows. If a new debt instrument that was issued under a Code Sec. 368(a)(1) plan of reorganization had an issue price (as otherwise determined for OID purposes) that was less than the adjusted issue price of the "old" debt instrument, then the "new" issue price is treated as equal to that "old" adjusted issue price.³

¶ 12468. Debt instrument issued as part of investment unit. If a debt instrument is issued as part of an investment unit that includes an option, security, or other property, the issue price of that investment unit must be determined by treating the entire unit as a debt instrument.⁴ The issue price for the investment unit is then allocated proportionately among the elements of the investment unit in the ratio that the FMV of each element bears to the total FMV of all elements. The issue price of the debt instrument included in the investment unit is the part of the total issue price allocated to it.⁵

However, if the FMV of the other elements of an investment unit is not readily ascertainable, then the part of the issue price allocated to the debt instrument is an assumed price. This assumed price is determined by comparing the yields at which debt instruments of a similar character which are not issued as part of an investment unit are sold in arm's length transactions, and by adjusting the price of the debt instrument issued as part of an investment unit to this yield.⁶

37. Code Sec. 1274A(c).

38. Code Sec. 1274A(d)(2).

39. Rev Rul 93-14, 1993-8 IRB 43.

40. Rev Rul 92-6, 1992-1 CB 295.

41. Rev Rul 91-11, 1991-1 CB 183.

42. Code Sec. 1274A(c).

43. Sec. 44(b)(4)(F), PL 98-369, 7/18/84 as added by Sec. 2, PL 98-612, 10/31/84 and amend by Sec. 1803(b)(1), PL 99-514, 10/22/86.

44. S Rept. PL 101-508, 11/5/90, p. 178.

45. S Rept. PL 101-508, 11/5/90, p. 178.

46. Conf Rept No. 101-964 (PL 101-508) p. 1098.

47. S Rept. PL 101-508, 11/5/90, p. 179.

48. Sec. 11325(c)(1), PL 101-508, 11/5/90.

49. Sec. 11325(c)(2)(a), PL 101-508, 11/5/90.

50. Sec. 11325(c)(2)(b), PL 101-508, 11/5/90.

1. Sec. 11325(c)(2)(c), PL 101-508, 11/5/90.

2. Sec. 11325(c)(2)(d), PL 101-508, 11/5/90.

3. Code Sec. 1275(a)(4) before amend by Sec. 11325(c)(2), PL 101-508, 11/5/90.

4. Code Sec. 1273(c)(2)(A).

5. Code Sec. 1273(c)(2)(B); Code Sec. 1273(c)(2)(C).

6. Reg § 1.1232-3(b)(2)(ii)(X).

An assumed issue price for the debt instrument agreed to by the issuer and the buyer will be presumed to be correct if made in arm's length negotiations between parties having adverse interests, provided it does not appear to be clearly erroneous.⁷

¶ 12469. **Convertible debt instruments.** The issue price of a convertible debt instrument issued at a discount includes any amount paid for the conversion privilege.⁸

Observation: This means that the issue price is increased (and therefore the OID is decreased) even though part of the amount paid is for the conversion feature.

¶ 12470. **Serial debt instruments.** Debt instruments may be issued serially, i.e., where some debt instruments mature at different dates than others. If a single debt instrument is payable in installments, each installment is treated as a separate debt instrument that matures on the date that the payment of that installment is due.⁹

If an independent issue price for each particular maturity can be established, then all of the debt instruments with that particular maturity are considered a separate series. The debt instruments of each separate series are treated as a separate issue with a separate issue price, maturity date, and stated redemption price at maturity.¹⁰

If an independent issue price cannot be established for each series, then the issue price for each series is determined as follows:

- (1) The total OID for all the debt instruments comprising the issue (regardless of series) is determined.
- (2) A fraction of the total OID is allocated to each series. The numerator of the fraction for a particular series equals the product of the total stated redemption price at maturity of the debt instruments in the series multiplied by the number of years (including any fraction of a year) from the date of original issue to the date the series matures. The denominator is the sum of the numerators for each series in the issue.
- (3) The part of the OID allocated to a series is then allocated to the debt instruments in the series, in accordance with the stated redemption price at maturity of each debt instrument.
- (4) The OID allocated to a debt instrument is then subtracted from the stated redemption price at maturity of that debt instrument to get that instrument's issue price.¹¹

¶ 12471. **Price level adjusted mortgages (PLAMs) treated as OID debt instruments.** A price level adjusted mortgage (PLAM) is a mortgage with a stated fixed rate of interest and a principal balance that is adjusted monthly for inflation.¹² For federal income tax purposes, a PLAM is treated as a debt bearing a variable rate of interest that changes monthly.¹³ A PLAM is considered to be issued with OID because a portion of the interest accruing on it is not paid currently but is added to the outstanding balance.¹⁴

The amount of OID accruing is equal to the interest accruing during each monthly accrual period, minus any qualified periodic interest payments¹⁵ (the portion of each payment attributable to the PLAM's stated fixed interest rate).¹⁶ Regs prescribe how to determine the amount of interest accruing during an accrual period.¹⁷ OID on a PLAM is taken into account currently under the "regular" Code Sec. 1272 OID rules (¶ 12472). For this purpose, the daily portion of OID on a PLAM is the total OID for a monthly accrual period, divided by the days in the accrual period.¹⁸

Debt instruments similar to PLAMs will be treated as PLAMs to the extent provided by IRS in revenue rulings (or other guidance).¹⁹

For PLAMs issued before Jan. 10, '90²⁰ the rules above were not in effect.

Amount of Currently Includible OID

¶ 12472. **Determining amount of OID currently includible in holder's income.** If the holder of a debt instrument issued with OID after Dec. 31, '84 is required to include part of the OID in gross income currently (¶ 12451), the amount includible for the holder's tax year equals the sum of the daily portions of the OID for each day during the tax year that the holder held the debt instrument.²¹

For debt instruments issued before Jan. 1, '85, see ¶ 12473 and ¶ 12474.

The daily portion of the OID on any debt instrument is determined by allocating to each day in any "accrual period" that day's ratable portion of the increase during that accrual period in the "adjusted issue price" of the debt instrument.²² This increase equals the excess of:

... the product of the adjusted issue price of the debt instrument at the beginning of that accrual period multiplied by its yield to maturity;²³ over

... the sum of the amounts payable as interest on the

7. Reg § 1.1232-3(b)(2)(ii)(B).

8. Reg § 1.163-3(b).

9. Reg § 1.1232-3(b)(2)(iv)(C).

10. Reg § 1.1232-3(b)(2)(iv)(A).

11. Reg § 1.1232-3(b)(2)(iv).

12. Reg § 1.1275-6T(b)(1)(i).

13. Reg § 1.1275-6T(c).

14. Preamble to TD 8281, 1/8/90.

15. Reg § 1.1275-6T(d)(1).

16. Reg § 1.1275-6T(d)(4).

17. Reg § 1.1275-6T(d)(2).

18. Reg § 1.1275-6T(d)(6).

19. Reg § 1.1275-6T(b)(1)(ii).

20. Reg § 1.1275-6T(g).

21. Code Sec. 1272(a)(1).

22. Code Sec. 1272(a)(3).

23. Code Sec. 1272(a)(3)(A).

debt instrument during that accrual period.²⁴

The yield to maturity is determined on the basis of compounding at the close of each accrual period. It is properly adjusted for the length of the accrual period.²⁵

"Accrual period" means, except as otherwise provided in regs, a six-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 six months before that maturity date.²⁶

The "adjusted issue price" of a debt instrument at the beginning of any accrual period equals the sum of the issue price of the debt instrument plus all adjustments (i.e., OID inclusions) in that issue price for all accrual periods before the first day of that accrual period.²⁷

Special rules apply to determine the amount of OID includible in the gross income of a holder of a regular interest in a REMIC (Real Estate Investment Mortgage Conduit, see ¶ 20600 *et seq.*) or any other debt instrument if payments under that debt instrument may be accelerated by reason of prepayments of obligations securing that debt instrument.²⁸

¶ 12473. Debt instruments issued before '85 and after July 1, '82—includible OID. For debt instruments issued with OID before Jan. 1, '85 and after July 1, '82 where the holder is required to include part of the OID in gross income currently (¶ 12451), the rules discussed at ¶ 12472 apply to determine the amount includible for any tax year of the holder. But for these obligations, the term "accrual period" means, except as otherwise provided in regs, a one-year period (or the shorter period to maturity) beginning on the day in the calendar year that corresponds to the date of original issue of the debt instrument.²⁹

¶ 12474. Corporate debt instruments issued before July 2, '82 and after May 27, '69—includible OID. If a corporate debt instrument is issued with OID before July 2, '82 and after May 27, '69, and if the holder is required to include part of the OID in gross income currently (¶ 12451), the amount includible for any tax year of the holder equals the ratable monthly portion of the OID (below), multiplied by the number of complete months (plus any fractional part of a month) that the holder holds the debt instrument during that tax year.³⁰

The ratable monthly portion of the OID equals the total OID on the instrument, divided by the number of complete months from the date of original issue to the

stated maturity date of the debt instrument.³¹ This means that the total OID is divided by the number of complete months plus any fractional part of a month in the period beginning on the date of original issue and ending on the day before the stated maturity date.³²

A complete month for this purpose means a month that begins on the date of original issue and on the corresponding day of each succeeding calendar month (or on the last day of that month if it has no corresponding day).³³

Illustration: Wedgewood Corp issued a debt instrument with a face value of \$100,000 (its stated redemption price at maturity) to S on Apr. 1, Year 1 for \$76,000. The debt instrument pays interest at a rate of 8% currently and matures on Apr. 1, Year 11. S, a calendar year taxpayer, holds the debt instrument through Dec. 31, Year 9. The OID on the debt instrument is \$24,000, i.e., \$100,000 less \$76,000.

There are 120 complete months (and no fractional part of a month) in the period beginning on Apr. 1, Year 1 (the date of issue) and ending on Mar. 31, Year 11 (the date before maturity). Accordingly, the ratable monthly portion is \$200, i.e., OID of \$24,000 divided by 120.

S includes \$2,400 of OID in gross income in Year 10, i.e., \$200 multiplied by twelve (the number of complete months he held the debt instrument in Year 10).

¶ 12475. Reduction in amount of OID currently includible in gross income by holder who pays acquisition premium. A holder of a debt instrument issued with OID who pays an acquisition premium on the purchase of that debt instrument is allowed to reduce the amount of OID includible in gross income. The amount of this reduction depends on whether the debt instrument was issued after July 1, '82, and if so, whether it was purchased after July 18, '84.³⁴

A holder's acquisition premium equals the excess of (a) the amount paid for the debt instrument over (b) the sum of the issue price and the part of the OID includible in the gross income of prior holders (without any reduction for any acquisition premium paid by any prior holder).³⁵

A holder of a debt instrument issued after July 1, '82 who, after July 18, '84, pays an acquisition premium on buying it reduces each includible daily portion of OID as follows. The amount of the reduction for any daily portion equals the amount of that daily portion (before reduction) multiplied by this fraction:

24. Code Sec. 1272(a)(3)(B).

25. Code Sec. 1272(a)(3)(A).

26. Code Sec. 1272(a)(5).

27. Code Sec. 1272(a)(4).

28. Code Sec. 1272(a)(6).

29. Code Sec. 1232A(a)(5) before repeal by Sec. 42(a)(1), PL 98-369, 07/18/84; Sec. 44(i), PL 98-369, 07/18/84.

30. Code Sec. 1272(b)(1).

31. Code Sec. 1272(b)(2).

32. Reg. § 1.1232-3A(a)(2).

33. Code Sec. 1273(b)(3)(A).

34. Code Sec. 1272(a)(7).

35. Code Sec. 1272(a)(7)(B).

The numerator is the excess of (a) the cost of the debt instrument to the buyer over (b) the sum of the issue price plus the part of the OID previously includible in the gross income of any holder without any reduction under the rule in this paragraph. The denominator is the sum of the daily OID portions (computed without any reduction under this rule) for the debt instrument for all days after the date of purchase and ending on the stated maturity date.³⁶

Observation: Under the rule in Code Sec. 1272(a)(7)(footnote 36), the reduction increases as the amount of the daily portion (before reduction) increases.

A holder of a debt instrument issued after July 1, '82 who, before July 19, '84, paid an acquisition premium on buying it reduces each includible daily portion of OID by the excess of (a) his cost for the debt instrument over (b) the issue price of the debt instrument plus the sum of the daily portions for the debt instrument for all days before the date of purchase (computed without reduction to any prior holder under the rule discussed in this paragraph), divided by the number of days beginning on the date of purchase and ending on the day before the stated maturity date.³⁷ This means that each daily portion is reduced by an equal amount.³⁸

A buyer who pays an acquisition premium for a corporate debt instrument issued before July 2, '82 and after May 27, '69 reduces his ratable monthly portion of the includible OID for each month he holds the debt instrument, by that month's share of the acquisition premium. This monthly share is the excess of (a) the cost of the debt instrument to the holder over (b) the sum of the issue price plus the portion of OID includible in the gross income of any holder (before reduction under the rule of this paragraph), divided by the number of complete months (plus any fractional part of a month) from the date of purchase to the date of maturity.³⁹

For acquisition premium on indebtedness acquired by person related to the debtor, see ¶ 12966.

Stripped Bonds, Stripped Coupons, and Stripped Preferred Stock

¶ 12476. Applicability of OID current inclusion rules to stripped bonds and stripped coupons. If, after July 1, '82 a person buys a bond (including a tax-exempt bond, see ¶ 12478) with one or more coupons stripped, then that bond or coupon is treated as a bond originally issued with OID, on that purchase date. This treatment applies to the bond or coupon

during the period it is held by the buyer or by any person whose basis in the bond is determined by reference to the buyer's basis in it.⁴⁰

The amount of "deemed" OID on a stripped bond is the excess of its stated redemption price at maturity (¶ 12455) over the bond's ratable share of the purchase price. The amount of "deemed" OID on a stripped coupon is the excess of the amount payable on the due date of the coupon over the coupon's ratable share of the purchase price.⁴¹

The ratable share is determined on the basis of the respective fair market values, on the purchase date, of the stripped bonds and stripped coupons.⁴²

Observation: If the date of purchase is after Dec. 31, '84, the amount of OID includible currently will be determined under the rules discussed at ¶ 12472. This is because the stripped bond or stripped coupon is then treated as a bond with OID issued after Dec. 31, '84. On the other hand, if the date of purchase was before Jan. 1, '85, the amount includible currently is determined under the rules discussed at ¶ 12473.

OID on stripped bonds or stripped bond coupons (other than any tax-exempt portion of the OID determined under Code Sec. 1286(d)(2), see ¶ 12478) will be treated as zero if it is less than the de minimis amount determined under the "regular" OID rules (¶ 12454).⁴³ For purposes of the de minimis computation of OID under Code Sec. 1273(a)(3), the number of complete years to maturity is measured from the date the stripped bond or stripped coupon is purchased.⁴⁴

For a purchase or sale of a stripped tax-exempt bond or coupon before Oct. 23, '86, the deemed OID rules didn't apply to tax-exempt obligations.⁴⁵

¶ 12477. Treatment of transferor of stripped bond or stripped coupon. Any person (transferor) who strips one or more coupons from a bond and then (after July 1, '82) disposes of either the bond or the coupon(s) is treated as having purchased the retained item or items (i.e., stripped bond or stripped coupon or coupons). The purchase is deemed made on the date of the disposition. The deemed purchase price of each retained item equals the part of the transferor's basis in the bond and coupons immediately before the disposition that is allocated to that item.⁴⁶ This basis allocation is done according to the respective fair market values of the items retained by the transferor and the items disposed of by him.⁴⁷

The transferor must include in his gross income an amount equal to the interest accrued on the bond

36. Code Sec. 1272(a)(7).

37. Code Sec. 1232A(a)(6) before repeal by Sec. 42(a)(1), PL 98-369, 07/18/84; Sec. 44(i)(2), PL 98-369, 7/18/84.

38. Conf Rept No. 98-861 (PL 98-369) p. 803.

39. Code Sec. 1272(b)(4).

40. Code Sec. 1286(a).

41. Code Sec. 1286(a).

42. Code Sec. 1286(a).

43. Reg § 1.1286-1(a).

44. Reg § 1.1286-1(a).

45. Code Sec. 1286(d)(1) before amend by Sec. 1879(s), PL 99-514, 10/22/86.

46. Code Sec. 1286(b)(4).

47. Code Sec. 1286(b)(3).

while he held it and before the bond or the coupon was disposed of, plus the accrued market discount on the bond determined as of the time the coupon or bond was disposed of (but only to the extent that he hasn't already included that accrued interest or discount).⁴⁸ The transferor increases his basis in the bond and coupons by the amount that he thus includes in income.⁴⁹

If a person (transferee) has a basis in any stripped bond or stripped coupon that is determined by reference to its basis in the hands of a person (transferor) who has disposed of it after July 1, '82, then a rule similar to the deemed purchase rule will apply to the transferee.⁵⁰

Observation: This means that a transferee who carries over the transferor's basis in full is treated as having purchased the stripped bond or stripped coupon transferred to him, on the date of transfer for a purchase price equal to the part of the transferor's basis allocated to the transferred item. Presumably, if the basis of the transferred item in the transferee's hands is determined by reference to the basis in the transferor's hands but is not exactly the same as the transferor's basis, the transferee will be treated as having purchased the transferred item for an amount equal to the basis of the item in his hands and not the basis in the transferor's hands.

¶ 12478. Applicability of OID rules to tax-exempt obligations that are stripped. A tax-exempt obligation (¶ 13006) from which one or more coupons have been stripped is subject to the deemed OID current inclusion rules described at ¶ 12476, with certain modifications described below.¹

The amount of OID taken into account will be partially tax-exempt. To the extent the discount exceeds the tax-exempt portion, it is treated as OID on a taxable obligation.²

The tax-exempt portion is the excess of (1) the stated redemption price at maturity over (2) an issue price which would produce a yield to maturity as of the purchase date equal to the lower of: the coupon rate of interest on the obligation from which the coupons were separated, or the yield to maturity (based on the purchase price) of the stripped obligation or coupon. The buyer of any stripped obligation or coupon may elect to substitute the original yield to maturity for the coupon rate of interest in this calculation.³ Unlike the case with taxable obligations (¶ 12477), the transferor of a tax-exempt stripped bond or coupon is not required to include in income either the interest accrued before the transfer or the

accrued market discount on the bonds (as determined at the time the bond is disposed of) which hasn't previously been included in income.⁴

The transferor's basis in a stripped tax-exempt bond or coupon is increased by the sum of the interest accrued but not paid (and not previously reflected in basis) before the bond or coupon(s) was disposed of, plus the amount included in gross income as accrued market discount (¶ 12500).⁵

If a tax-exempt obligation or coupon was held for sale in the ordinary course of the seller's trade or business on June 10, '87, then the rules for taxable obligations apply (1) to that seller, and (2) to the obligation or coupon while it is held by the person who purchased it from that seller.⁶

For purchases and sales before June 11, '87 the amount of OID was the lower of the coupon rate on the tax-exempt obligation or the actual yield on the stripped bond or coupon.⁸

For obligations issued before Oct. 23, '86, the transferor of a stripped bond or coupon did not have to include accrued market discount in income at the time of stripping a bond or coupon.⁹

¶ 12479. OID current inclusion rules applied to preferred stock that is stripped. A person who purchases any stripped preferred stock (i.e., preferred stock that was stripped of some or all of its dividend rights, see ¶ 12480) must, while holding the stock, include in gross income the amounts that would have been includible if the preferred stock were a bond issued on the purchase date with OID equal to the excess of the stock's redemption price over the purchase price.¹⁰

Observation: The calculation of income required to be recognized under this rule, like the calculation of OID, requires the existence of a maturity date. Presumably, this is the earliest date at which the holder can demand that the shares be redeemed at the fixed redemption price. Where no such date exists, it is unclear how the rules would apply.

Any amount included in gross income under this rule is treated as ordinary income¹¹ other than interest or dividends.¹²

Observation: Presumably, a corporate holder of stripped preferred stock wouldn't be able to claim the dividends-received deduction with respect to these amounts.

"Purchase" means any acquisition of stock where

48. Code Sec. 1286(b)(1).

49. Code Sec. 1286(b)(2).

50. Code Sec. 1286(b).

1. Code Sec. 1286(d).

2. Code Sec. 1286(d)(1)(A)(ii).

3. Code Sec. 1286(d)(2).

4. Code Sec. 1286(d)(1)(B).

5. Code Sec. 1286(d)(1)(C).

6. Sec. 1018(q)(4)(b)(ii), PL 100-647, 11/10/88.

7. Sec. 1018(q)(4)(b), PL 100-647, 11/10/88.

8. Code Sec. 1286(d)(1) before amend by Sec. 1018(q)(4)(a), PL 100-647, 11/10/88.

9. Sec. 1803(a)(13)(c), PL 99-514, 10/22/86.

10. Code Sec. 305(e)(1).

11. Code Sec. 305(e)(4).

12. H Rept No. 103-111 (PL 103-66), p. 641.

the basis of the stock isn't determined in whole or in part by reference to the adjusted basis of the stock in the hands of the person from whom it was acquired.¹³

These rules apply to any person who purchases the stock after Apr. 30, '93, and to any person whose basis in the stock is determined by reference to its basis in the hands of a post-Apr. 30, '93 purchaser.¹⁴

Observation: Thus, where stock is bought before May 1, '93 and then transferred after Apr. 30, '93 in a completely tax-free transaction with basis carryover (e.g., a partnership contribution), these rules don't apply.

For basis adjustments, see ¶ 11822.

For how person who strips the stock is treated, see ¶ 12481.

For treatment of stripped dividend holders, see ¶ 14057.

¶ 12480. Stripped preferred stock defined. For purposes of applying the OID current inclusion rule to stripped preferred stock, stripped preferred stock is stock that:

- ... is limited and preferred as to dividends,
- ... doesn't participate in corporate growth to any significant degree,
- ... has a fixed redemption price, and
- ... has been stripped—i.e., there has been a separation in ownership between the stock and any dividend on the stock that hasn't yet become payable.¹⁵

¶ 12481. Treatment of transferor of stripped preferred stock. Any person who strips the rights to one or more dividends from any preferred stock (¶ 12480) and who, after Apr. 30, '93 disposes of those dividend right or rights, is treated as having bought the stripped preferred stock on the date that he disposed of the dividend right(s), for a purchase price equal to his adjusted basis in the stripped preferred stock.¹⁶

Observation: Code Sec. 305(e)(3) says that the purchase price of the stripped preferred stock is considered to equal the stripper's adjusted basis in the stock, but doesn't say as of what date this adjusted basis is to be determined.

¶ 12500. Accrued Market Discount Treated As Interest Income on Sale of Bonds.

Gain on the disposition of any "market discount bond" is treated as ordinary income to the extent of the "accrued market discount" on the bond. But taxpayers may elect to take market discount into income as it accrues.

✓ for in-depth discussion, see RIA's Federal Tax Coordinator 2d Chapter J, and RIA's Analysis of Federal Taxes: Income Chapter J.

¶ 12501. Disposition of market discount bonds. Gain on the disposition of any "market discount bond" (¶ 12502) is treated as ordinary income to the extent of the "accrued market discount" on the bond (¶ 12504).¹ For election to include the accrued market discount currently, see ¶ 12505.

Observation: Any recognized gain in excess of the accrued market discount would be capital gain if the bond was a capital asset.

If the disposition of the bond is in a transaction other than a sale, exchange or involuntary conversion, the amount realized on the disposition is equal to the bond's fair market value.²

The amounts treated as ordinary income under this rule are treated as interest income under all provisions of the tax law *except*:

... Code Sec. 103 (dealing with tax-exempt obligations, see ¶ 13000 *et seq.*).

... Code Secs. 871(a) and 881 (dealing with the U.S. tax on nonresident aliens and foreign corporations for income not effectively connected with a U.S. business, see ¶s 30109, 30286).

... Code Secs. 1441 and 1442 (dealing with tax withholding on nonresident aliens and foreign corporations, see ¶ 30650 *et seq.*).

... Code Sec. 6049 (dealing with information returns required by the payors of interest, see ¶ 60105 *et seq.*), and

... any other provision specified under regs.³

¶ 12502. "Market discount bond" defined. A "market discount bond" is any bond, debenture, note, certificate, or other evidence of indebtedness having a "market discount" (¶ 12503)⁴ *other than*:

... a short-term obligation, i.e., with a fixed maturity date of not more than one year from the issue date,

13. Code Sec. 305(e)(6).

14. Code Sec. 305(e)(1).

15. Code Sec. 305(e)(3).

16. Code Sec. 305(e)(3).

1. Code Sec. 1276(a)(1).

2. Code Sec. 1276(a)(2).

3. Code Sec. 1276(a)(4).

4. Code Sec. 1278(a)(1)(A); Code Sec. 1278(a)(3).