

new debt instrument is \$600. Thus, under section 1273(a), the debt instrument has OID of \$150. The exchange qualifies as a recapitalization under section 368(a)(1)(E), with the consequence that, under sections 354 and 358, H recognizes no loss on the exchange and has an adjusted basis in the new debt instrument of \$1,000.

(ii) *Application of section 1272(c)(1)*. Under paragraphs (b)(1) and (b)(2) of this section, H purchases the new debt instrument at a premium of \$250. Accordingly, under section 1272(c)(1), H is not required to include OID in income with respect to the new debt instrument.

Example 3. Debt-for-debt exchange where holder is considered to purchase new debt instrument at an acquisition premium—(i) Facts. The facts are the same as in *Example 2* of paragraph (c) of this section, except that H purchases the old debt instrument from another holder on July 1, 1995, and on July 1, 1997, H's adjusted basis in the old debt instrument is \$700. Under section 1273(a), the new debt instrument is issued with OID of \$150.

(ii) *Application of section 1272(a)(7)*. Under paragraphs (b)(1) and (b)(3) of this section, H purchases the new debt instrument at an acquisition premium of \$100. Accordingly, the daily portion of OID that is includible in H's income is reduced by the fraction determined under section 1272(a)(7).

Example 4. Treatment of acquisition premium for debt instrument acquired by gift—(i) Facts. On July 1, 1994, D receives as a gift a debt instrument with a stated redemption price at maturity of \$1,000 and an adjusted issue price of \$800. On that date, the fair market value of the debt instrument is \$900 and the donor's adjusted basis in the debt instrument is \$950.

(ii) *Application of section 1272(a)(7)*. Under paragraphs (b)(1), (b)(3), and (b)(6)(ii) of this section, D is considered to have purchased the debt instrument at an acquisition premium of \$150. Accordingly, the daily portion of OID that is includible in D's income is reduced by the fraction determined under section 1272(a)(7).

[T.D. 8517, 59 FR 4814, Feb. 2, 1994]

§ 1.1272-3 Election by a holder to treat all interest on a debt instrument as OID.

(a) *Election*. A holder of a debt instrument may elect to include in gross income all interest that accrues on the instrument by using the constant yield method described in paragraph (c) of this section. For purposes of this election, interest includes stated interest, acquisition discount, OID, de minimis OID, market discount, de minimis market discount, and unstated interest, as

adjusted by any amortizable bond premium or acquisition premium.

(b) *Scope of election—(1) In general*. Except as provided in paragraph (b)(2) of this section, a holder may make the election for any debt instrument.

(2) *Exceptions, limitations, and special rules—(i) Debt instrument with amortizable bond premium (as determined under section 171)*. (A) A holder may make the election for a debt instrument with amortizable bond premium only if the instrument qualifies as a bond under section 171(d).

(B) If a holder makes the election under this section for a debt instrument with amortizable bond premium, the holder is deemed to have made the election under section 171(c)(2) for the taxable year in which the instrument was acquired. If the holder has previously made the election under section 171(c)(2), the requirements of that election with respect to any debt instrument are satisfied by electing to amortize the bond premium under the rules provided by this section.

(ii) *Debt instrument with market discount*. (A) A holder may make the election under this section for a debt instrument with market discount only if the holder is eligible to make an election under section 1278(b).

(B) If a holder makes the election under this section for a debt instrument with market discount, the holder is deemed to have made both the election under section 1276(b)(2) for that instrument and the election under section 1278(b) for the taxable year in which the instrument was acquired. If the holder has previously made the election under section 1278(b), the requirements of that election with respect to any debt instrument are satisfied by electing to include the market discount in income in accordance with the rules provided by this section.

(iii) *Tax-exempt debt instrument*. A holder may not make the election for a tax-exempt obligation as defined in section 1275(a)(3).

(c) *Mechanics of the constant yield method—(1) In general*. For purposes of this section, the amount of interest that accrues during an accrual period is determined under rules similar to those under section 1272 (the constant

yield method). In applying the constant yield method, however, a debt instrument subject to the election is treated as if—

(i) The instrument is issued for the holder's adjusted basis immediately after its acquisition by the holder;

(ii) The instrument is issued on the holder's acquisition date; and

(iii) None of the interest payments provided for in the instrument are qualified stated interest payments.

(2) *Special rules to determine adjusted basis.* For purposes of paragraph (c)(1)(i) of this section—

(i) If the debt instrument is acquired in an exchange for other property (other than in a reorganization defined in section 368) and the basis of the debt instrument is determined, in whole or in part, by reference to the basis of the other property, the adjusted basis of the debt instrument may not exceed its fair market value immediately after the exchange; and

(ii) If the debt instrument was acquired with amortizable bond premium (as determined under section 171), the adjusted basis of the debt instrument is reduced by an amount equal to the value attributable to any conversion feature.

(d) *Time and manner of making the election.* The election must be made for the taxable year in which the holder acquires the debt instrument. A holder makes the election by attaching to the holder's timely filed Federal income tax return a statement that the holder is making an election under this section and that identifies the debt instruments subject to the election. A holder may make the election for a class or group of debt instruments by attaching a statement describing the type or types of debt instruments being designated for the election.

(e) *Revocation of election.* The election may not be revoked unless approved by the Commissioner.

(f) *Effective date.* This section applies to debt instruments acquired on or after April 4, 1994.

[T.D. 8517, 59 FR 4815, Feb. 2, 1994]

§ 1.1273-1 Definition of OID.

(a) *In general.* Section 1273(a)(1) defines OID as the excess of a debt instrument's stated redemption price at ma-

turity over its issue price. Section 1.1273-2 defines issue price, and paragraph (b) of this section defines stated redemption price at maturity. Paragraph (d) of this section provides rules for de minimis amounts of OID. Although the total amount of OID for a debt instrument may be indeterminate, §1.1272-1(d) provides a rule to determine OID accruals on certain debt instruments that provide for a fixed yield. See *Example 10* in §1.1272-1(j).

(b) *Stated redemption price at maturity.* A debt instrument's stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments. If the payment schedule of a debt instrument is determined under §1.1272-1(c) (relating to certain debt instruments subject to contingencies), that payment schedule is used to determine the instrument's stated redemption price at maturity.

(c) *Qualified stated interest—(1) Definition—(i) In general.* Qualified stated interest is stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer), or that will be constructively received under section 451, at least annually at a single fixed rate (within the meaning of paragraph (c)(1)(iii) of this section).

(ii) *Unconditionally payable.* Interest is unconditionally payable only if reasonable legal remedies exist to compel timely payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment a remote contingency (within the meaning of §1.1275-2(h)). For purposes of the preceding sentence, remedies or other terms and conditions are not taken into account if the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions. For purposes of determining whether interest is unconditionally payable, the possibility of nonpayment due to default, insolvency, or similar circumstances, or due to the exercise of a conversion option described in §1.1272-1(e) is ignored. This