

§ 1.171-1

26 CFR Ch. I (4-1-02 Edition)

(j) *Effective date.* Except as otherwise provided in § 1.170A-14(g)(4)(ii), this section applies only to contributions made on or after December 18, 1980.

[T.D. 8069, 51 FR 1499, Jan. 14, 1986; 51 FR 5322, Feb. 13, 1986; 51 FR 6219, Feb. 21, 1986, as amended by T.D. 8199, 53 FR 16085, May 5, 1988; T.D. 8540, 59 FR 30105, June 10, 1994; T.D. 8619, 64 FR 23228, Apr. 30, 1999]

§ 1.171-1 Bond premium.

(a) *Overview*—(1) *In general.* This section and §§ 1.171-2 through 1.171-5 provide rules for the determination and amortization of bond premium by a holder. In general, a holder amortizes bond premium by offsetting the interest allocable to an accrual period with the premium allocable to that period. Bond premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond premium is intended to generally conform the treatment of bond premium to the treatment of original issue discount under sections 1271 through 1275. Unless otherwise provided, the terms used in this section and §§ 1.171-2 through 1.171-5 have the same meaning as those terms in sections 1271 through 1275 and the corresponding regulations. Moreover, unless otherwise provided, the provisions of this section and §§ 1.171-2 through 1.171-5 apply in a manner consistent with those of sections 1271 through 1275 and the corresponding regulations. In addition, the anti-abuse rule in § 1.1275-2(g) applies for purposes of this section and §§ 1.171-2 through 1.171-5.

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

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

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

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

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

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

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

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

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

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

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

(d) *Determination of bond premium*—(1) *In general.* A holder acquires a bond at a premium if the holder's basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments

of qualified stated interest). This excess is bond premium, which is amortizable under § 1.171-2.

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

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

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

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

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

(B) *Convertible bonds acquired in certain exchanges.* If the bond is a convertible bond acquired in a transaction de-

scribed in paragraph (e)(1)(ii) of this section, the holder's basis in the bond may not exceed its fair market value immediately after the exchange reduced by the value of the conversion option.

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

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

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

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

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

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

(ii) *Determination of basis.* Under section 732(b), PR's basis in the bond is equal to PR's basis in the partnership interest. Therefore, PR's basis for determining loss on the sale or exchange of the bond is \$100,000. However, because the distribution is treated as an exchange for purposes of section 171(b)(4), PR's basis in the bond is \$40,000 for purposes of this section and §§ 1.171-2 through 1.171-5. See paragraph (e)(1)(ii) of this section.

Example 2. Convertible bond—(i) Facts. On January 11, 1998, A purchases for \$1,100 B corporation's bond maturing on January 1, 2001, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$30 on

January 1 and July 1 of each year. In addition, the bond is convertible into 15 shares of B corporation stock at the option of the holder. On January 1, 1998, B corporation's nonconvertible, publicly-traded, three-year debt with a similar credit rating trades at a price that reflects a yield of 6.75 percent, compounded semiannually.

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

[T.D. 8746, 62 FR 68177, Dec. 31, 1997]

§ 1.171-2 Amortization of bond premium.

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

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

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

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

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

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

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

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

(B) *Carryforward.* If the bond premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as a deduction for the accrual period under paragraph