

§ 1.1271-1

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(2) Variable rate debt instrument that provides for annual payments of interest at a single variable rate.

(3) All other variable rate debt instruments except for those that provide for a fixed rate.

(4) Variable rate debt instrument that provides for a single fixed rate.

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§ 1.1271-1 Special rules applicable to amounts received on retirement, sale, or exchange of debt instruments.

(a) *Intention to call before maturity*—(1) *In general.* For purposes of section 1271(a)(2), all or a portion of gain realized on a sale or exchange of a debt instrument to which section 1271 applies is treated as interest income if there was an intention to call the debt instrument before maturity. An intention to call a debt instrument before maturity means a written or oral agreement or understanding not provided for in the debt instrument between the issuer and the original holder of the debt instrument that the issuer will redeem the debt instrument before maturity. In the case of debt instruments that are part of an issue, the agreement or understanding must be between the issuer and the original holders of a substantial amount of the debt instruments in the issue. An intention to call before maturity can exist even if the intention is conditional (e.g., the issuer's decision to call depends on the financial condition of the issuer on the potential call date) or is not legally binding. For purposes of this section, original holder means the first holder (other than an underwriter or dealer that purchased the debt instrument for resale in the ordinary course of its trade or business).

(2) *Exceptions.* In addition to the exceptions provided in sections 1271(a)(2)(B) and 1271(b), section 1271(a)(2) does not apply to—

(i) A debt instrument that is publicly offered (as defined in §1.1275-1(h));

(ii) A debt instrument to which section 1272(a)(6) applies (relating to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or

(iii) A debt instrument sold pursuant to a private placement memorandum that is distributed to more than ten offerees and that is subject to the sanctions of section 12(2) of the Securities Act of 1933 (15 U.S.C. 771) or the prohibitions of section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j).

(b) *Short-term obligations*—(1) *In general*. Under sections 1271 (a)(3) and (a)(4), all or a portion of the gain realized on the sale or exchange of a short-term government or nongovernment obligation is treated as interest income. Sections 1271 (a)(3) and (a)(4), however, do not apply to any short-term obligation subject to section 1281. See §1.1272-1(f) for rules to determine if an obligation is a short-term obligation.

(2) *Method of making elections*. Elections to accrue on a constant yield basis under sections 1271 (a)(3)(E) and (a)(4)(D) are made on an obligation-by-obligation basis by reporting the transaction on the basis of daily compounding on the taxpayer's timely filed Federal income tax return for the year of the sale or exchange. These elections are irrevocable.

(3) *Counting conventions*. In computing the ratable share of acquisition discount under section 1271(a)(3) or OID under section 1271(a)(4), any reasonable counting convention may be used (e.g., 30 days per month/360 days per year).

[T.D. 8517, 59 FR 4809, Feb. 2, 1994]

§ 1.1272-1 Current inclusion of OID in income.

(a) *Overview*—(1) *In general*. Under section 1272(a)(1), a holder of a debt instrument includes accrued OID in gross income (as interest), regardless of the holder's regular method of accounting. A holder includes qualified stated interest (as defined in §1.1273-1(c)) in income under the holder's regular method of accounting. See §§1.446-2 and 1.451-1.

(2) *Debt instruments not subject to OID inclusion rules*. Sections 1272(a)(2) and 1272(c) list exceptions to the general inclusion rule of section 1272(a)(1). For purposes of section 1272(a)(2)(E) (relating to certain loans between natural persons), a loan does not include a stripped bond or stripped coupon within the meaning of section 1286(e), and the rule in section 1272(a)(2)(E)(iii), which treats a husband and wife as 1 person, does not apply to loans made between a husband and wife.

(b) *Accrual of OID*—(1) *Constant yield method*. Except as provided in paragraphs (b)(2) and (b)(3) of this section, the amount of OID includible in the income of a holder of a debt instrument for any taxable year is determined using the constant yield method as described under this paragraph (b)(1).

(i) *Step one: Determine the debt instrument's yield to maturity*. The yield to maturity or yield of a debt instrument is the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument. The yield must be constant over the term of the debt instrument and, when expressed as a percentage, must be calculated to at least two decimal places. See paragraph (c) of this section for rules relating to the yield of certain debt instruments subject to contingencies.

(ii) *Step two: Determine the accrual periods*. An accrual period is an interval of time over which the accrual of OID is measured. Accrual periods may be of any length and may vary in length over the term of the debt instrument, provided that each accrual period is no longer than 1 year and each scheduled payment of principal or interest occurs either on the final day of an accrual period or on the first day of an accrual period. In general, the computation of OID is simplest if accrual periods correspond to the intervals between payment dates provided by the terms of the debt instrument. In computing the length of accrual periods, any reasonable counting convention may be used (e.g., 30 days per month/360 days per year).

(iii) *Step three: Determine the OID allocable to each accrual period*. Except as