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 maturity 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 paragraph (c)(1)(ii) applies to debt instruments issued on or after August 13, 1996.

(iii) *Single fixed rate*—(A) *In general.* Interest is payable at a single fixed rate only if the rate appropriately takes into account the length of the interval between payments. Thus, if the interval between payments varies during the term of the debt instrument, the value of the fixed rate on which a payment is based generally must be adjusted to reflect a compounding assumption that is consistent with the length of the interval preceding the payment. See *Example 1* in paragraph (f) of this section.

(B) *Special rule for certain first and final payment intervals.* Notwithstanding paragraph (c)(1)(iii)(A) of this section, if a debt instrument provides for payment intervals that are equal in length throughout the term of the instrument, except that the first or final payment interval differs in length from the other payment intervals, the first or final interest payment is considered to be made at a fixed rate if the value of the rate on which the payment is based is adjusted in any reasonable manner to take into account the length of the interval. See *Example 2* of paragraph (f) of this section. The rule in this paragraph (c)(1)(iii)(B) also applies if the lengths of both the first and final payment intervals differ from the length of the other payment intervals.

(2) *Debt instruments subject to contingencies.* The determination of whether a debt instrument described in §1.1272–1(c) (a debt instrument providing for an alternative payment schedule (or schedules) upon the occurrence of one or more contingencies) provides for qualified stated interest is made by analyzing each alternative payment schedule (including the stated payment schedule) as if it were the debt instrument's sole payment schedule. Under this analysis, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. See *Example (4)* of paragraph (f) of this section.

(3) *Variable rate debt instrument.* In the case of a variable rate debt instrument, qualified stated interest is determined under §1.1275–5(e).

(4) *Stated interest in excess of qualified stated interest.* To the extent that stated interest payable under a debt instrument exceeds qualified stated interest, the excess is included in the debt instrument's stated redemption price at maturity.

(5) *Short-term obligations.* In the case of a debt instrument with a term that is not more than 1 year from the date of issue, no payments of interest are treated as qualified stated interest payments.

(d) *De minimis OID*—(1) *In general.* If the amount of OID with respect to a debt instrument is less than the de minimis amount, the amount of OID is treated as zero, and all stated interest (including stated interest that would otherwise be characterized as OID) is treated as qualified stated interest.

(2) *De minimis amount.* The de minimis amount is an amount equal to 0.0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date.

(3) *Installment obligations.* In the case of an installment obligation (as defined in paragraph (e)(1) of this section), paragraph (d)(2) of this section is applied by substituting for the number of complete years to maturity the weighted average maturity (as defined in paragraph (e)(3) of this section). Alternatively, in the case of a debt instrument that provides for payments of principal no more rapidly than a self-amortizing installment obligation (as defined in paragraph (e)(2) of this section), the de minimis amount defined in paragraph (d)(2) of this section may be calculated by substituting 0.00167 for 0.0025.

(4) *Special rule for interest holidays, teaser rates, and other interest shortfalls*—(i) *In general.* This paragraph (d)(4) provides a special rule to determine whether a debt instrument with a teaser rate (or rates), an interest holiday, or any other interest shortfall has de minimis OID. This rule applies if—

(A) The amount of OID on the debt instrument is more than the de minimis amount as otherwise determined under paragraph (d) of this section; and

(B) All stated interest provided for in the debt instrument would be qualified stated interest under paragraph (c) of this section except that for 1 or more accrual periods the interest rate is below the rate applicable for the remainder of the instrument's term (e.g., if as a result of an interest holiday, none of the stated interest is qualified stated interest).

(ii) *Redetermination of OID for purposes of the de minimis test.* For purposes of determining whether a debt instrument described in paragraph (d)(4)(i) of this section has de minimis OID, the instrument's stated redemption price at maturity is treated as equal to the instrument's issue price plus the greater of the amount of foregone interest or the excess (if any) of the instrument's stated principal amount over its issue price. The amount of foregone interest is the amount of additional stated interest that would be required to be payable on the debt instrument during the period of the teaser rate, holiday, or shortfall so that all stated interest would be qualified stated interest under paragraph (c) of this section. See *Example 5* and *Example 6* of paragraph (f) of this section. In addition, for purposes of computing the de minimis amount of OID, the weighted average maturity of the debt instrument is determined by treating all stated interest payments as qualified stated interest payments.

(5) *Treatment of de minimis OID by holders*—(i) *Allocation of de minimis OID to principal payments.* The holder of a debt instrument includes any de minimis OID (other than de minimis OID treated as qualified stated interest under paragraph (d)(1) of this section, such as de minimis OID attributable to a teaser rate or interest holiday) in income as stated principal payments are made. The amount includible in income with respect to each principal payment equals the product of the total amount of de minimis OID on the debt instrument and a fraction, the numerator of which is the amount of the principal payment made and the denominator of which is the stated principal amount of the instrument.

(ii) *Character of de minimis OID*—(A) *De minimis OID treated as gain recognized on retirement.* Any amount of de minimis OID includible in income under this paragraph (d)(5) is treated as gain recognized on retirement of the debt instrument. See section 1271 to determine whether a retirement is treated as an exchange of the debt instrument.

(B) *Treatment of de minimis OID on sale or exchange.* Any gain attributable to de minimis OID that is recognized on the sale or exchange of a debt instrument is capital gain if the debt instrument is a capital asset in the hands of the seller.

(iii) *Treatment of subsequent holders.* If a subsequent holder purchases a debt instrument issued with de minimis OID at a premium (as defined in §1.1272–2(b)(2)), the subsequent holder does not include the de minimis OID in income. Otherwise, a subsequent holder includes any discount in income under the market discount rules (sections 1276 through 1278) rather than under the rules of this paragraph (d)(5).

(iv) *Cross-reference.* See §1.1272–3 for an election by a holder to treat de minimis OID as OID.

(e) *Definitions*—(1) *Installment obligation.* An installment obligation is a debt instrument that provides for the payment of any amount other than qualified stated interest before maturity.

(2) *Self-amortizing installment obligation.* A self-amortizing installment obligation is an obligation that provides for equal payments composed of principal and qualified stated interest that are unconditionally payable at least annually during the entire term of the debt instrument with no significant additional payment required at maturity.

(3) *Weighted average maturity.* The weighted average maturity of a debt instrument is the sum of the following amounts determined for each payment under the instrument (other than a payment of qualified stated interest)—

(i) The number of complete years from the issue date until the payment is made; multiplied by

(ii) A fraction, the numerator of which is the amount of the payment and the denominator of which is the debt instrument's stated redemption price at maturity.

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

Example 1. Qualified stated interest—(i) *Facts.* On January 1, 1995, A purchases at original issue, for $100,000, a debt instrument that matures on January 1, 1999, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for interest payments of $8,000 on January 1, 1996, and January 1, 1997, and quarterly interest payments of $1,942.65, beginning on April 1, 1997.

(ii) *Amount of qualified stated interest.* The annual payments of $8,000 and the quarterly payments of $1,942.65 are payable at a single fixed rate because 8 percent, compounded annually, is equivalent to 7.77 percent, compounded quarterly. Consequently, all stated interest payments under the debt instrument are qualified stated interest payments.

Example 2. Qualified stated interest with short initial payment interval. On October 1, 1994, A purchases at original issue, for $100,000, a debt instrument that matures on January 1, 1998, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for an interest payment of $2,000 on January 1, 1995, and interest payments of $8,000 on January 1, 1996, January 1, 1997, and January 1, 1998. Under paragraph (c)(1)(iii)(B) of this section, all stated interest payments on the debt instrument are computed at a single fixed rate and are qualified stated interest payments.

Example 3. Stated interest in excess of qualified stated interest—(i) *Facts.* On January 1, 1995, B purchases at original issue, for $100,000, C corporation's 5-year debt instrument. The debt instrument provides for a principal payment of $100,000, payable at maturity, and calls for annual interest payments of $10,000 for the first 3 years and annual interest payments of $10,600 for the last 2 years.

(ii) *Payments in excess of qualified stated interest.* All of the first three interest payments and $10,000 of each of the last two interest payments are qualified stated interest payments within the meaning of paragraph (c)(1) of this section. Under paragraph (c)(4) of this section, the remaining $600 of each of the last two interest payments is included in the stated redemption price at maturity, so that the stated redemption price at maturity is $101,200. Pursuant to paragraph (e)(3) of this section, the weighted average maturity of the debt instrument is 4.994 years [(4 years×$600/$101,200)+(5 years×$100,600/$101,200)]. The de minimis amount, or one-fourth of 1 percent of the stated redemption price at maturity multiplied by the weighted average maturity, is $1,263.50. Because the actual amount of discount, $1,200, is less than the de minimis amount, the instrument is treated as having no OID, and, under paragraph (d)(1) of this section, all of the interest payments are treated as qualified stated interest payments.

Example 4. Qualified stated interest on a debt instrument that is subject to an option—(i) *Facts.* On January 1, 1997, A issues, for $100,000, a 10-year debt instrument that provides for a $100,000 principal payment at maturity and for annual interest payments of $10,000. Under the terms of the debt instrument, A has the option, exercisable on January 1, 2002, to lower the annual interest payments to $8,000. In addition, the debt instrument gives the holder an unconditional right to put the debt instrument back to A, exercisable on January 1, 2002, in return for $100,000.

(ii) *Amount of qualified stated interest.* Under paragraph (c)(2) of this section, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. If the payment schedule determined by assuming that the issuer's option will be exercised and the put option will not be exercised were treated as the debt instrument's sole payment schedule, only $8,000 of each annual interest payment would be qualified stated interest. Under any other payment schedule, the debt instrument would provide for annual qualified stated interest payments of $10,000. Accordingly, only $8,000 of each annual interest payment is qualified stated interest. Any excess of each annual interest payment over $8,000 is included in the debt instrument's stated redemption price at maturity.

Example 5. De minimis OID; interest holiday—(i) *Facts.* On January 1, 1995, C purchases at original issue, for $97,561, a debt instrument that matures on January 1, 2007, and has a stated principal amount of $100,000, payable at maturity. The debt instrument provides for an initial interest holiday of 1 quarter and quarterly interest payments of $2,500 thereafter (beginning on July 1, 1995). The issue price of the debt instrument is $97,561. C chooses to accrue OID based on quarterly accrual periods.

(ii) *De minimis amount of OID.* But for the interest holiday, all stated interest on the debt instrument would be qualified stated interest. Under paragraph (d)(4) of this section, for purposes of determining whether the debt instrument has de minimis OID, the stated redemption price at maturity of the instrument is $100,061 ($97,561 (issue price) plus $2,500 (the greater of the amount of foregone interest ($2,500) and the amount equal to the excess of the instrument's stated principal amount over its issue price ($2,439)). Thus, the debt instrument is treated as having OID of $2,500 ($100,061 minus $97,561). Because this amount is less than the de minimis amount of $3,001.83 (0.0025 multiplied by $100,061 multiplied by 12 complete years to maturity), the debt instrument is treated as having no OID, and all stated interest is treated as qualified stated interest.

Example 6. De minimis OID; teaser rate—(i) *Facts.* The facts are the same as in *Example 5* of this paragraph (f) except that C uses an initial semiannual accrual period rather than an initial quarterly accrual period.

(ii) *De minimis amount of OID.* The debt instrument provides for an initial teaser rate because the interest rate for the semiannual accrual period is less than the interest rate applicable to the subsequent quarterly accrual periods. But for the initial teaser rate, all stated interest on the debt instrument would be qualified stated interest. Under paragraph (d)(4) of this section, for purposes of determining whether the debt instrument has de minimis OID, the stated redemption price at maturity of the instrument is $100,123.50 ($97,561 (issue price) plus $2,562.50 (the greater of the amount of foregone interest ($2,562.50) and the amount equal to the excess of the instrument's stated principal amount over its issue price ($2,439)). Thus, the debt instrument is treated as having OID of $2,562.50 ($100,123.50 minus $97,561). Because this amount is less than the de minimis amount of $3,003.71 (0.0025 multiplied by

$100,123.50 multiplied by 12 complete years to maturity), the debt instrument is treated as having no OID, and all stated interest is treated as qualified stated interest.

[T.D. 8517, 59 FR 4815, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30141, June 14, 1996]

§ 1.1273–2 Determination of issue price and issue date.

(a) *Debt instruments issued for money*—(1) *Issue price*. If a substantial amount of the debt instruments in an issue is issued for money, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money. Thus, if an issue consists of a single debt instrument that is issued for money, the issue price of the debt instrument is the amount paid for the instrument. For example, in the case of a debt instrument evidencing a loan to a natural person, the issue price of the instrument is the amount loaned. See § 1.1275–2(d) for rules regarding Treasury securities. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See § 1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(2) *Issue date*. The issue date of an issue described in paragraph (a)(1) of this section is the first settlement date or closing date, whichever is applicable, on which a substantial amount of the debt instruments in the issue is sold for money.

(b) *Publicly traded debt instruments issued for property*—(1) *Issue price*. If a substantial amount of the debt instruments in an issue is traded on an established market (within the meaning of paragraph (f) of this section) and the issue is not described in paragraph (a)(1) of this section, the issue price of each debt instrument in the issue is the fair market value of the debt instrument, determined as of the issue date (as defined in paragraph (b)(2) of this section).

(2) *Issue date*. The issue date of an issue described in paragraph (b)(1) of this section is the first date on which a substantial amount of the traded debt instruments in the issue is issued.

(c) *Debt instruments issued for publicly traded property*—(1) *Issue price*. If a substantial amount of the debt instruments in an issue is issued for property that is traded on an established market (within the meaning of paragraph (f) of this section) and the issue is not described in paragraph (a)(1) or (b)(1) of this section, the issue price of each debt instrument in the issue is the fair market value of the property, determined as of the issue date (as defined in paragraph (c)(2) of this section). For purposes of the preceding sentence, property means a debt instrument, stock, security, contract, commodity, or nonfunctional currency. But see § 1.988–2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(2) *Issue date*. The issue date of an issue described in paragraph (c)(1) of this section is the first date on which a substantial amount of the debt instruments in the issue is issued for traded property.

(d) *Other debt instruments*—(1) *Issue price*. If an issue of debt instruments is not described in paragraph (a)(1), (b)(1), or (c)(1) of this section, the issue price of each debt instrument in the issue is determined as if the debt instrument were a separate issue. If the issue price of a debt instrument that is treated as a separate issue under the preceding sentence is not determined under paragraph (a)(1), (b)(1), or (c)(1) of this section, and if section 1274 applies to the debt instrument, the issue price of the instrument is determined under section 1274. Otherwise, the issue price of the debt instrument is its stated redemption price at maturity under section 1273(b)(4). See section 1274(c) and § 1.1274–1 to determine if section 1274 applies to a debt instrument.

(2) *Issue date*. The issue date of an issue described in paragraph (d)(1) of this section is the date on which the debt instrument is issued for money or in a sale or exchange.

(e) *Special rule for certain sales to bond houses, brokers, or similar persons*. For purposes of determining the issue price and issue date of a debt instrument under this section, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored.