1272(a)(2), debt instruments issued by natural persons (as defined in §1.6049–4(f)(2)), certificates of deposit, REMIC regular interests or other debt instruments subject to section 1272(a)(6), or (unless otherwise required by the Commissioner pursuant to a revenue ruling or revenue procedure) stripped bonds and coupons (within the meaning of section 1286).

(d) *Application to foreign issuers and U.S. issuers of foreign-targeted debt instruments.* A foreign or domestic issuer is subject to the rules of this section with respect to an issue of debt instruments unless the issue is not offered for sale or resale in the United States in connection with its original issuance.

(e) *Penalties.* See section 6706 for rules relating to the penalty imposed for failure to meet the information reporting requirements imposed by this section.

(f) *Effective date.* Paragraphs (c), (d), and (e) of this section are effective for an issue of debt instruments issued after September 2, 1992.

[T.D. 8431, 57 FR 40322, Sept. 3, 1992; 57 FR 46243, Oct. 7, 1992, as amended by T.D. 8517, 59 FR 4827, Feb. 2, 1994; T.D. 8674, 61 FR 30143, June 14, 1996]

§1.1275–4 Contingent payment debt instruments.

(a) *Applicability*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, this section applies to any debt instrument that provides for one or more contingent payments. In general, paragraph (b) of this section applies to a contingent payment debt instrument that is issued for money or publicly traded property and paragraph (c) of this section applies to a contingent payment debt instrument that is issued for nonpublicly traded property. Paragraph (d) of this section provides special rules for tax-exempt obligations. See §1.1275–6 for a taxpayer's treatment of a contingent payment debt instrument and a hedge.

(2) *Exceptions.* This section does not apply to—

(i) A debt instrument that has an issue price determined under section 1273(b)(4) (e.g., a debt instrument subject to section 483);

(ii) A variable rate debt instrument (as defined in §1.1275–5);

(iii) A debt instrument subject to §1.1272–1(c) (a debt instrument that provides for certain contingencies) or §1.1272–1(d) (a debt instrument that provides for a fixed yield);

(iv) A debt instrument subject to section 988 (except as provided in section 988 and the regulations thereunder);

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

(vi) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (e.g., U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations);

(vii) An inflation-indexed debt instrument (as defined in §1.1275–7); or

(viii) A debt instrument issued pursuant to a plan or arrangement if—

(A) The plan or arrangement is created by a state statute;

(B) A primary objective of the plan or arrangement is to enable the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and

(C) Contingent payments on the debt instrument are related to such objective.

(3) *Insolvency and default.* A payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

(4) *Convertible debt instruments.* A debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the 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.

(5) *Remote and incidental contingencies.* A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. See §1.1275–2(h) for the treatment of remote and incidental contingencies.

(b) *Noncontingent bond method*—(1) *Applicability.* The noncontingent bond

method described in this paragraph (b) applies to a contingent payment debt instrument that has an issue price determined under §1.1273–2 (e.g., a contingent payment debt instrument that is issued for money or publicly traded property).

(2) *In general.* Under the noncontingent bond method, interest on a debt instrument must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of interest that is taken into account for each accrual period is determined by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument. If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference.

(3) *Description of method.* The following steps describe how to compute the amount of income, deductions, gain, and loss under the noncontingent bond method:

(i) *Step one: Determine the comparable yield.* Determine the comparable yield for the debt instrument under the rules of paragraph (b)(4) of this section. The comparable yield is determined as of the debt instrument's issue date.

(ii) *Step two: Determine the projected payment schedule.* Determine the projected payment schedule for the debt instrument under the rules of paragraph (b)(4) of this section. The projected payment schedule is determined as of the issue date and remains fixed throughout the term of the debt instrument (except under paragraph (b)(9)(ii) of this section, which applies to a payment that is fixed more than 6 months before it is due).

(iii) *Step three: Determine the daily portions of interest.* Determine the daily portions of interest on the debt instrument for a taxable year as follows. The amount of interest that accrues in each accrual period is the product of the comparable yield of the debt instrument (properly adjusted for the length of the accrual period) and the debt instrument's adjusted issue price at the beginning of the accrual period. See paragraph (b)(7)(ii) of this section to determine the adjusted issue price of the debt instrument. The daily portions of interest are determined by allocating to each day in the accrual period the ratable portion of the interest that accrues in the accrual period. Except as modified by paragraph (b)(3)(iv) of this section, the daily portions of interest are includible in income by a holder for each day in the holder's taxable year on which the holder held the debt instrument and are deductible by the issuer for each day during the issuer's taxable year on which the issuer was primarily liable on the debt instrument.

(iv) *Step four: Adjust the amount of income or deductions for differences between projected and actual contingent payments.* Make appropriate adjustments to the amount of income or deductions attributable to the debt instrument in a taxable year for any differences between projected and actual contingent payments. See paragraph (b)(6) of this section to determine the amount of an adjustment and the treatment of the adjustment.

(4) *Comparable yield and projected payment schedule.* This paragraph (b)(4) provides rules for determining the comparable yield and projected payment schedule for a debt instrument. The comparable yield and projected payment schedule must be supported by contemporaneous documentation showing that both are reasonable, are based on reliable, complete, and accurate data, and are made in good faith.

(i) *Comparable yield*—(A) *In general.* Except as provided in paragraph (b)(4)(i)(B) of this section, the comparable yield for a debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions. For example, if a §1.1275–6 hedge (or the substantial equivalent) is available, the comparable yield is the yield on the synthetic fixed rate debt instrument that would result if the issuer entered into the §1.1275–6 hedge. If a §1.1275–6 hedge (or the substantial equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at

a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. The comparable yield must be a reasonable yield for the issuer and must not be less than the applicable Federal rate (based on the overall maturity of the debt instrument).

(B) *Presumption for certain debt instruments.* This paragraph (b)(4)(i)(B) applies to a debt instrument if the instrument provides for one or more contingent payments not based on market information and the instrument is part of an issue that is marketed or sold in substantial part to persons for whom the inclusion of interest under this paragraph (b) is not expected to have a substantial effect on their U.S. tax liability. If this paragraph (b)(4)(i)(B) applies to a debt instrument, the instrument's comparable yield is presumed to be the applicable Federal rate (based on the overall maturity of the debt instrument). A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield (determined using the principles in paragraph (b)(4)(i)(A) of this section) that is higher than the applicable Federal rate. The presumption may not be overcome with appraisals or other valuations of nonpublicly traded property. Evidence used to overcome the presumption must be specific to the issuer and must not be based on comparable issuers or general market conditions.

(ii) *Projected payment schedule.* The projected payment schedule for a debt instrument includes each noncontingent payment and an amount for each contingent payment determined as follows:

(A) *Market-based payments.* If a contingent payment is based on market information (a market-based payment), the amount of the projected payment is the forward price of the contingent payment. The forward price of a contingent payment is the amount one party would agree, as of the issue date, to pay an unrelated party for the right to the contingent payment on the settlement date (e.g., the date the contingent payment is made). For example, if the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable Federal rate from the issue date to the date the contingent payment is due.

(B) *Other payments.* If a contingent payment is not based on market information (a non-market-based payment), the amount of the projected payment is the expected value of the contingent payment as of the issue date.

(C) *Adjustments to the projected payment schedule.* The projected payment schedule must produce the comparable yield. If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted consistent with the principles of this paragraph (b)(4) to produce the comparable yield. For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for the market-based payments.

(iii) *Market information.* For purposes of this paragraph (b), market information is any information on which an objective rate can be based under §1.1275–5(c) (1) or (2).

(iv) *Issuer/holder consistency.* The issuer's projected payment schedule is used to determine the holder's interest accruals and adjustments. The issuer must provide the projected payment schedule to the holder in a manner consistent with the issuer disclosure rules of §1.1275–2(e). If the issuer does not create a projected payment schedule for a debt instrument or the issuer's projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and projected payment schedule for the debt instrument under the rules of this paragraph (b)(4). A holder that determines its own projected payment

schedule must explicitly disclose this fact and the reason why the holder set its own schedule (e.g., why the issuer's projected payment schedule is unreasonable). Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

(v) *Issuer's determination respected*—(A) *In general.* If the issuer maintains the contemporaneous documentation required by this paragraph (b)(4), the issuer's determination of the comparable yield and projected payment schedule will be respected unless either is unreasonable.

(B) *Unreasonable determination.* For purposes of paragraph (b)(4)(v)(A) of this section, a comparable yield or projected payment schedule generally will be considered unreasonable if it is set with a purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. In a determination of whether a comparable yield or projected payment schedule is unreasonable, consideration will be given to whether the treatment of the debt instrument under this section is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. For example, if a taxable issuer markets a debt instrument to a holder not subject to U.S. taxation, the comparable yield will be given close scrutiny and will not be respected unless contemporaneous documentation shows that the yield is not too high.

(C) *Exception.* Paragraph (b)(4)(v)(A) of this section does not apply to a debt instrument subject to paragraph (b)(4)(i)(B) of this section (concerning a yield presumption for certain debt instruments that provide for non-market-based payments).

(vi) *Examples.* The following examples illustrate the provisions of this paragraph (b)(4). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Market-based payment—(i) *Facts.* On December 31, 1996, X corporation issues for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest, beginning in 1997, at the rate of 6 percent and for a payment at maturity equal to $1,000,000 plus the excess, if any, of the price of 10,000 shares of publicly traded stock in an unrelated corporation on the maturity date over $350,000, or less the excess, if any, of $350,000 over the price of 10,000 shares of the stock on the maturity date. On the issue date, the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000.

(ii) *Comparable yield.* Under paragraph (b)(4)(i) of this section, the debt instrument's comparable yield is the yield on the synthetic debt instrument that would result if X corporation entered into a §1.1275–6 hedge. A §1.1275–6 hedge in this case is a forward contract to purchase 10,000 shares of the stock on December 31, 2006. If X corporation entered into this hedge, the resulting synthetic debt instrument would yield 6 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6 percent, compounded annually.

(iii) *Projected payment schedule.* Under paragraph (b)(4)(ii) of this section, the projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. Because the right to the contingent payment is based on market information, the projected amount of the contingent payment is the forward price of the payment. The right to the contingent payment is substantially similar to a right to a payment of $1,000,000 combined with a cash-settled forward contract for the purchase of 10,000 shares of the stock for $350,000 on December 31, 2006. Because the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000, the amount to be received or paid under the forward contract is projected to be zero. As a result, the projected amount of the contingent payment at maturity is $1,000,000, consisting of the $1,000,000 base amount and no additional amount to be received or paid under the forward contract.

(A) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $370,000. If X corporation entered into a §1.1275–6 hedge (a forward contract to purchase the shares for $370,000), the resulting synthetic debt instrument would yield 6.15 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6.15 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $1,020,000, consisting of the $1,000,000 base amount plus the excess $20,000 of the forward

price of the stock over the purchase price of the stock under the forward contract.

(B) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $330,000. If X corporation entered into a §1.1275–6 hedge, the resulting synthetic debt instrument would yield 5.85 percent, compounded annually. Thus, the comparable yield on the debt instrument is 5.85 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $980,000, consisting of the $1,000,000 base amount minus the excess $20,000 of the purchase price of the stock under the forward contract over the forward price of the stock.

Example 2. Non-market-based payments—(i) *Facts.* On December 31, 1996, Y issues to Z for $1,000,000 a debt instrument that matures on December 31, 2000. The debt instrument has a stated principal amount of $1,000,000, payable at maturity, and provides for payments on December 31 of each year, beginning in 1997, of $20,000 plus 1 percent of Y's gross receipts, if any, for the year. On the issue date, Y has outstanding fixed rate debt instruments with maturities of 2 to 10 years that trade at a price that reflects an average of 100 basis points over Treasury bonds. These debt instruments have terms and conditions similar to those of the debt instrument. Assume that on December 31, 1996, 4-year Treasury bonds have a yield of 6.5 percent, compounded annually, and that no §1.1275–6 hedge is available for the debt instrument. In addition, assume that the interest inclusions attributable to the debt instrument are expected to have a substantial effect on Z's U.S. tax liability.

(ii) *Comparable yield.* The comparable yield for the debt instrument is equal to the value of the benchmark rate (i.e., the yield on 4-year Treasury bonds) on the issue date plus the spread. Thus, the debt instrument's comparable yield is 7.5 percent, compounded annually.

(iii) *Projected payment schedule.* Y anticipates that it will have no gross receipts in 1997, but that it will have gross receipts in later years, and those gross receipts will grow each year for the next three years. Based on its business projections, Y believes that it is not unreasonable to expect that its gross receipts in 1999 and each year thereafter will grow by between 6 percent and 13 percent over the prior year. Thus, Y must take these expectations into account in establishing a projected payment schedule for the debt instrument that results in a yield of 7.5 percent, compounded annually. Accordingly, Y could reasonably set the following projected payment schedule for the debt instrument:

Date	Noncontingent payment	Contingent payment
12/31/1997	$20,000	$0
12/31/1998	20,000	70,000
12/31/1999	20,000	75,600
12/31/2000	1,020,000	83,850

(5) *Qualified stated interest.* No amounts payable on a debt instrument to which this paragraph (b) applies are qualified stated interest within the meaning of §1.1273–1(c).

(6) *Adjustments.* This paragraph (b)(6) provides rules for the treatment of positive and negative adjustments under the noncontingent bond method. A taxpayer takes into account only those adjustments that occur during a taxable year while the debt instrument is held by the taxpayer or while the taxpayer is primarily liable on the debt instrument.

(i) *Determination of positive and negative adjustments.* If the amount of a contingent payment is more than the projected amount of the contingent payment, the difference is a positive adjustment on the date of the payment. If the amount of a contingent payment is less than the projected amount of the contingent payment, the difference is a negative adjustment on the date of the payment (or on the scheduled date of the payment if the amount of the payment is zero).

(ii) *Treatment of net positive adjustments.* The amount, if any, by which total positive adjustments on a debt instrument in a taxable year exceed the total negative adjustments on the debt instrument in the taxable year is a net positive adjustment. A net positive adjustment is treated as additional interest for the taxable year.

(iii) *Treatment of net negative adjustments.* The amount, if any, by which total negative adjustments on a debt instrument in a taxable year exceed the total positive adjustments on the debt instrument in the taxable year is a net negative adjustment. A taxpayer's net negative adjustment on a debt instrument for a taxable year is treated as follows:

(A) *Reduction of interest accruals.* A net negative adjustment first reduces interest for the taxable year that the taxpayer would otherwise account for

on the debt instrument under paragraph (b)(3)(iii) of this section.

(B) *Ordinary income or loss.* If the net negative adjustment exceeds the interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section, the excess is treated as ordinary loss by a holder and ordinary income by an issuer. However, the amount treated as ordinary loss by a holder is limited to the amount by which the holder's total interest inclusions on the debt instrument exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years. The amount treated as ordinary income by an issuer is limited to the amount by which the issuer's total interest deductions on the debt instrument exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years.

(C) *Carryforward.* If the net negative adjustment exceeds the sum of the amounts treated by the taxpayer as a reduction of interest and as ordinary income or loss (as the case may be) on the debt instrument for the taxable year, the excess is a negative adjustment carryforward for the taxable year. In general, a taxpayer treats a negative adjustment carryforward for a taxable year as a negative adjustment on the debt instrument on the first day of the succeeding taxable year. However, if a holder of a debt instrument has a negative adjustment carryforward on the debt instrument in a taxable year in which the debt instrument is sold, exchanged, or retired, the negative adjustment carryforward reduces the holder's amount realized on the sale, exchange, or retirement. If an issuer of a debt instrument has a negative adjustment carryforward on the debt instrument for a taxable year in which the debt instrument is retired, the issuer takes the negative adjustment carryforward into account as ordinary income.

(D) *Treatment under section 67.* A net negative adjustment is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions).

(iv) *Cross-references.* If a holder has a basis in a debt instrument that is different from the debt instrument's adjusted issue price, the holder may have additional positive or negative adjustments under paragraph (b)(9)(i) of this section. If the amount of a contingent payment is fixed more than 6 months before the date it is due, the amount and timing of the adjustment are determined under paragraph (b)(9)(ii) of this section.

(7) *Adjusted issue price, adjusted basis, and retirement*—(i) *In general.* If a debt instrument is subject to the noncontingent bond method, this paragraph (b)(7) provides rules to determine the adjusted issue price of the debt instrument, the holder's basis in the debt instrument, and the treatment of any scheduled or unscheduled retirements. In general, because any difference between the actual amount of a contingent payment and the projected amount of the payment is taken into account as an adjustment to income or deduction, the projected payments are treated as the actual payments for purposes of making adjustments to issue price and basis and determining the amount of any contingent payment made on a scheduled retirement.

(ii) *Definition of adjusted issue price.* The adjusted issue price of a debt instrument is equal to the debt instrument's issue price, increased by the interest previously accrued on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument. See paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iii) *Adjustments to basis.* A holder's basis in a debt instrument is increased by the interest previously accrued by the holder on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any

noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. See paragraph (b)(9)(i) of this section for special rules that apply when basis is different from adjusted issue price and paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iv) *Scheduled retirements.* For purposes of determining the amount realized by a holder and the repurchase price paid by the issuer on the scheduled retirement of a debt instrument, a holder is treated as receiving, and the issuer is treated as paying, the projected amount of any contingent payment due at maturity. If the amount paid or received is different from the projected amount, see paragraph (b)(6) of this section for the treatment of the difference by the taxpayer. Under paragraph (b)(6)(iii)(C) of this section, the amount realized by a holder on the retirement of a debt instrument is reduced by any negative adjustment carryforward determined in the taxable year of the retirement.

(v) *Unscheduled retirements.* An unscheduled retirement of a debt instrument (or the receipt of a pro-rata prepayment that is treated as a retirement of a portion of a debt instrument under §1.1275–2(f)) is treated as a repurchase of the debt instrument (or a pro-rata portion of the debt instrument) by the issuer from the holder for the amount paid by the issuer to the holder.

(vi) *Examples.* The following examples illustrate the provisions of paragraphs (b) (6) and (7) of this section. In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Treatment of positive and negative adjustments—(i) *Facts.* On December 31, 1996, Z, a calendar year taxpayer, purchases a debt instrument subject to this paragraph (b) at original issue for $1,000. The debt instrument's comparable yield is 10 percent, compounded annually, and the projected payment schedule provides for payments of $500 on December 31, 1997 (consisting of a noncontingent payment of $375 and a projected amount of $125) and $660 on December 31, 1998 (consisting of a noncontingent payment of $600 and a projected amount of $60). The debt instrument is a capital asset in the hands of Z.

(ii) *Adjustment in 1997.* Based on the projected payment schedule, Z's total daily portions of interest on the debt instrument are $100 for 1997 (issue price of $1,000 × 10 percent). Assume that the payment actually made on December 31, 1997, is $375, rather than the projected $500. Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $125 on December 31, 1997, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z has no positive adjustments for 1997, Z has a net negative adjustment of $125 on the debt instrument for 1997. This net negative adjustment reduces to zero the $100 total daily portions of interest Z would otherwise include in income in 1997. Accordingly, Z has no interest income on the debt instrument for 1997. Because Z had no interest inclusions on the debt instrument for prior taxable years, the remaining $25 of the net negative adjustment is a negative adjustment carryforward for 1997 that results in a negative adjustment of $25 on January 1, 1998.

(iii) *Adjustment to issue price and basis.* Z's total daily portions of interest on the debt instrument are $100 for 1997. The adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are increased by this amount, despite the fact that Z does not include this amount in income because of the net negative adjustment for 1997. In addition, the adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are decreased on December 31, 1997, by the projected amount of the payment on that date ($500). Thus, on January 1, 1998, Z's adjusted basis in the debt instrument and the adjusted issue price of the debt instrument are $600.

(iv) *Adjustments in 1998.* Based on the projected payment schedule, Z's total daily portions of interest are $60 for 1998 (adjusted issue price of $600 × 10 percent). Assume that the payment actually made on December 31, 1998, is $700, rather than the projected $660. Under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $40 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z also has a negative adjustment of $25 on January 1, 1998, Z has a net positive adjustment of $15 on the debt instrument for 1998 (the excess of the $40 positive adjustment over the $25 negative adjustment). As a result, Z has $75 of interest income on the debt instrument for 1998 (the $15 net positive adjustment plus the $60 total daily portions of interest that are taken into account by Z in that year).

(v) *Retirement.* Based on the projected payment schedule, Z's adjusted basis in the debt instrument immediately before the payment at maturity is $660 ($600 plus $60 total daily portions of interest for 1998). Even though Z receives $700 at maturity, for purposes of determining the amount realized by Z on retirement of the debt instrument, Z is treated as receiving the projected amount of the contingent payment on December 31, 1998. Therefore, Z is treated as receiving $660 on December 31, 1998. Because Z's adjusted basis in the debt instrument immediately before its retirement is $660, Z recognizes no gain or loss on the retirement.

Example 2. Negative adjustment carryforward for year of sale—(i) *Facts.* Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that Z sells the debt instrument on January 1, 1998, for $630.

(ii) *Gain on sale.* On the date the debt instrument is sold, Z's adjusted basis in the debt instrument is $600. Because Z has a negative adjustment of $25 on the debt instrument on January 1, 1998, and has no positive adjustments on the debt instrument in 1998, Z has a net negative adjustment for 1998 of $25. Because Z has not included in income any interest on the debt instrument, the entire $25 net negative adjustment is a negative adjustment carryforward for the taxable year of the sale. Under paragraph (b)(6)(iii)(C) of this section, the $25 negative adjustment carryforward reduces the amount realized by Z on the sale of the debt instrument from $630 to $605. Thus, Z has a gain on the sale of $5 ($605 − $600). Under paragraph (b)(8)(i) of this section, the gain is treated as interest income.

Example 3. Negative adjustment carryforward for year of retirement—(i) *Facts.* Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that the payment actually made on December 31, 1998, is $615, rather than the projected $660.

(ii) *Adjustments in 1998.* Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $45 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. In addition, Z has a negative adjustment of $25 on January 1, 1998. See *Example 1*(ii) of this paragraph (b)(7)(vi). Because Z has no positive adjustments in 1998, Z has a net negative adjustment of $70 for 1998. This net negative adjustment reduces to zero the $60 total daily portions of interest Z would otherwise include in income for 1998. Therefore, Z has no interest income on the debt instrument for 1998. Because Z had no interest inclusions on the debt instrument for 1997, the remaining $10 of the net negative adjustment is a negative adjustment carryforward for 1998 that reduces the amount realized by Z on retirement of the debt instrument.

(iii) *Loss on retirement.* Immediately before the payment at maturity, Z's adjusted basis in the debt instrument is $660. Under paragraph (b)(7)(iv) of this section, Z is treated as receiving the projected amount of the contingent payment, or $660, as the payment at maturity. Under paragraph (b)(6)(iii)(C) of this section, however, this amount is reduced by any negative adjustment carryforward determined for the taxable year of retirement to calculate the amount Z realizes on retirement of the debt instrument. Thus, Z has a loss of $10 on the retirement of the debt instrument, equal to the amount by which Z's adjusted basis in the debt instrument ($660) exceeds the amount Z realizes on the retirement of the debt instrument ($660 minus the $10 negative adjustment carryforward). Under paragraph (b)(8)(ii) of this section, the loss is a capital loss.

(8) *Character on sale, exchange, or retirement*—(i) *Gain.* Any gain recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is interest income.

(ii) *Loss.* Any loss recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is ordinary loss to the extent that the holder's total interest inclusions on the debt instrument exceed the total net negative adjustments on the debt instrument the holder took into account as ordinary loss. Any additional loss is treated as loss from the sale, exchange, or retirement of the debt instrument. However, any loss that would otherwise be ordinary under this paragraph (b)(8)(ii) and that is attributable to the holder's basis that could not be amortized under section 171(b)(4) is loss from the sale, exchange, or retirement of the debt instrument.

(iii) *Special rule if there are no remaining contingent payments on the debt instrument*—(A) *In general.* Notwithstanding paragraphs (b)(8) (i) and (ii) of this section, if, at the time of the sale, exchange, or retirement of the debt instrument, there are no remaining contingent payments due on the debt instrument under the projected payment schedule, any gain or loss recognized by the holder is gain or loss from the sale, exchange, or retirement of the debt instrument. See paragraph (b)(9)(ii) of this section to determine whether there are no remaining contingent payments on a debt instrument

that provides for fixed but deferred contingent payments.

(B) *Exception for certain positive adjustments.* Notwithstanding paragraph (b)(8)(iii)(A) of this section, if a positive adjustment on a debt instrument is spread under paragraph (b)(9)(ii) (F) or (G) of this section, any gain recognized by the holder on the sale, exchange, or retirement of the instrument is treated as interest income to the extent of the positive adjustment that has not yet been accrued and included in income by the holder.

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (b)(8). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Gain on sale—(i) *Facts.* On January 1, 1998, D, a calendar year taxpayer, sells a debt instrument that is subject to paragraph (b) of this section for $1,350. The projected payment schedule for the debt instrument provides for contingent payments after January 1, 1998. On January 1, 1998, D has an adjusted basis in the debt instrument of $1,200. In addition, D has a negative adjustment carryforward of $50 for 1997 that, under paragraph (b)(6)(iii)(C) of this section, results in a negative adjustment of $50 on January 1, 1998. D has no positive adjustments on the debt instrument on January 1, 1998.

(ii) *Character of gain.* Under paragraph (b)(6) of this section, the $50 negative adjustment on January 1, 1998, results in a negative adjustment carryforward for 1998, the taxable year of the sale of the debt instrument. Under paragraph (b)(6)(iii)(C) of this section, the negative adjustment carryforward reduces the amount realized by D on the sale of the debt instrument from $1,350 to $1,300. As a result, D realizes a $100 gain on the sale of the debt instrument, equal to the $1,300 amount realized minus D's $1,200 adjusted basis in the debt instrument. Under paragraph (b)(8)(i) of this section, the gain is interest income to D.

Example 2. Loss on sale—(i) *Facts.* On December 31, 1996, E, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument is a capital asset in the hands of E. The debt instrument provides for a single payment on December 31, 1998 (the maturity date of the instrument), of $1,000 plus an amount based on the increase, if any, in the price of a specified commodity over the term of the instrument. The comparable yield for the debt instrument is 9.54 percent, compounded annually, and the projected payment schedule provides for a payment of $1,200 on December 31, 1998. Based on the projected payment schedule, the total daily portions of interest are $95 for 1997 and $105 for 1998.

(ii) *Ordinary loss.* Assume that E sells the debt instrument for $1,050 on December 31, 1997. On that date, E has an adjusted basis in the debt instrument of $1,095 ($1,000 original basis, plus total daily portions of $95 for 1997). Therefore, E realizes a $45 loss on the sale of the debt instrument ($1,050–$1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, the $45 loss is an ordinary loss.

(iii) *Capital loss.* Alternatively, assume that E sells the debt instrument for $990 on December 31, 1997. E realizes a $105 loss on the sale of the debt instrument ($990 − $1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, $95 of the $105 loss is an ordinary loss. The remaining $10 of the $105 loss is a capital loss.

(9) *Operating rules.* The rules of this paragraph (b)(9) apply to a debt instrument subject to the noncontingent bond method notwithstanding any other rule of this paragraph (b).

(i) *Basis different from adjusted issue price.* This paragraph (b)(9)(i) provides rules for a holder whose basis in a debt instrument is different from the adjusted issue price of the debt instrument (e.g., a subsequent holder that purchases the debt instrument for more or less than the instrument's adjusted issue price).

(A) *General rule.* The holder accrues interest under paragraph (b)(3)(iii) of this section and makes adjustments under paragraph (b)(3)(iv) of this section based on the projected payment schedule determined as of the issue date of the debt instrument. However, upon acquiring the debt instrument, the holder must reasonably allocate any difference between the adjusted issue price and the basis to daily portions of interest or projected payments over the remaining term of the debt instrument. Allocations are taken into

account under paragraphs (b)(9)(i) (B) and (C) of this section.

(B) *Basis greater than adjusted issue price.* If the holder's basis in the debt instrument exceeds the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a negative adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is reduced by the amount the holder treats as a negative adjustment under this paragraph (b)(9)(i)(B). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(C) *Basis less than adjusted issue price.* If the holder's basis in the debt instrument is less than the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a positive adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is increased by the amount the holder treats as a positive adjustment under this paragraph (b)(9)(i)(C). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(D) *Premium and discount rules do not apply.* The rules for accruing premium and discount in sections 171, 1272(a)(7), 1276, and 1281 do not apply. Other rules of those sections, such as section 171(b)(4), continue to apply to the extent relevant.

(E) *Safe harbor for exchange listed debt instruments.* If the debt instrument is exchange listed property (within the meaning of § 1.1273–2(f)(2)), it is reasonable for the holder to allocate any difference between the holder's basis and the adjusted issue price of the debt instrument pro-rata to daily portions of interest (as determined under paragraph (b)(3)(iii) of this section) over the remaining term of the debt instrument. A pro-rata allocation is not reasonable, however, to the extent the holder's yield on the debt instrument, determined after taking into account the amounts allocated under this paragraph (b)(9)(i)(E), is less than the applicable Federal rate for the instrument. For purposes of the preceding sentence, the applicable Federal rate for the debt instrument is determined as if the purchase date were the issue date and the remaining term of the instrument were the term of the instrument.

(F) *Examples.* The following examples illustrate the provisions of this paragraph (b)(9)(i). In each example, assume that the instrument described is a debt instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes. In addition, assume that each instrument is not exchange listed property.

Example 1. Basis greater than adjusted issue price—(i) *Facts.* On July 1, 1998, Z purchases for $1,405 a debt instrument that matures on December 31, 1999, and promises to pay on the maturity date $1,000 plus the increase, if any, in the price of a specified amount of a commodity from the issue date to the maturity date. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for a single payment at maturity of $1,350. At the time of the purchase, the debt instrument has an adjusted issue price of $1,162, assuming semiannual accrual periods ending on December 31 and June 30 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment and not to a decrease in market interest rates. The debt instrument is a capital asset in the hands of Z. Z is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Z's basis in the debt instrument on July 1, 1998, is $1,405. Under paragraph (b)(9)(i)(A) of this section, Z allocates the $243 difference between basis ($1,405) and adjusted issue price ($1,162) to the contingent payment at maturity. Z's allocation of the difference between basis and adjusted issue price is reasonable because the increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment.

(iii) *Treatment of debt instrument for 1998.* Based on the projected payment schedule, $60 of interest accrues on the debt instrument

from July 1, 1998 to December 31, 1998 (the product of the debt instrument's adjusted issue price on July 1, 1998 ($1,162) and the comparable yield properly adjusted for the length of the accrual period (10.25 percent/2)). Z has no net negative or positive adjustments for 1998. Thus, Z includes in income $60 of total daily portions of interest for 1998. On December 31, 1998, Z's adjusted basis in the debt instrument is $1,465 ($1,405 original basis, plus total daily portions of $60 for 1998).

(iv) *Effect of allocation to contingent payment at maturity.* Assume that the payment actually made on December 31, 1999, is $1,400, rather than the projected $1,350. Thus, under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $50 on December 31, 1999. In addition, under paragraph (b)(9)(i)(B) of this section, Z has a negative adjustment of $243 on December 31, 1999, which is attributable to the difference between Z's basis in the debt instrument on July 1, 1998, and the instrument's adjusted issue price on that date. As a result, Z has a net negative adjustment of $193 for 1999. This net negative adjustment reduces to zero the $128 total daily portions of interest Z would otherwise include in income in 1999. Accordingly, Z has no interest income on the debt instrument for 1999. Because Z had $60 of interest inclusions for 1998, $60 of the remaining $65 net negative adjustment is treated by Z as an ordinary loss for 1999. The remaining $5 of the net negative adjustment is a negative adjustment carryforward for 1999 that reduces the amount realized by Z on the retirement of the debt instrument from $1,350 to $1,345.

(v) *Loss at maturity.* On December 31, 1999, Z's basis in the debt instrument is $1,350 ($1,405 original basis, plus total daily portions of $60 for 1998 and $128 for 1999, minus the negative adjustment of $243). As a result, Z realizes a loss of $5 on the retirement of the debt instrument (the difference between the amount realized on the retirement ($1,345) and Z's adjusted basis in the debt instrument ($1,350)). Under paragraph (b)(8)(ii) of this section, the $5 loss is treated as loss from the retirement of the debt instrument. Consequently, Z realizes a total loss of $65 on the debt instrument for 1999 (a $60 ordinary loss and a $5 capital loss).

Example 2. Basis less than adjusted issue price—(i) *Facts.* On January 1, 1999, Y purchases for $910 a debt instrument that pays 7 percent interest semiannually on June 30 and December 31 of each year, and that promises to pay on December 31, 2001, $1,000 plus or minus $10 times the positive or negative difference, if any, between a specified amount and the value of an index on December 31, 2001. However, the payment on December 31, 2001, may not be less than $650. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 9.80 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for semiannual payments of $35 and a contingent payment at maturity of $1,175. On January 1, 1999, the debt instrument has an adjusted issue price of $1,060, assuming semiannual accrual periods ending on December 31 and June 30 of each year. Y is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Y's basis in the debt instrument on January 1, 1999, is $910. Under paragraph (b)(9)(i)(A) of this section, Y must allocate the $150 difference between basis ($910) and adjusted issue price ($1,060) to daily portions of interest or to projected payments. These amounts will be positive adjustments taken into account at the time the daily portions accrue or the payments are made.

(A) Assume that, because of a decrease in the relevant index, the expected value of the payment at maturity has declined by about 9 percent. Based on forward prices on January 1, 1999, Y determines that approximately $105 of the difference between basis and adjusted issue price is allocable to the contingent payment. Y allocates the remaining $45 to daily portions of interest on a pro-rata basis (i.e., the amount allocated to an accrual period equals the product of $45 and a fraction, the numerator of which is the total daily portions for the accrual period and the denominator of which is the total daily portions remaining on the debt instrument on January 1, 1999). This allocation is reasonable.

(B) Assume alternatively that, based on yields of comparable debt instruments and its purchase price for the debt instrument, Y determines that an appropriate yield for the debt instrument is 13 percent, compounded semiannually. Based on this determination, Y allocates $55.75 of the difference between basis and adjusted issue price to daily portions of interest as follows: $15.19 to the daily portions of interest for the taxable year ending December 31, 1999; $18.40 to the daily portions of interest for the taxable year ending December 31, 2000; and $22.16 to the daily portions of interest for the taxable year ending December 31, 2001. Y allocates the remaining $94.25 to the contingent payment at maturity. This allocation is reasonable.

(ii) *Fixed but deferred contingent payments.* This paragraph (b)(9)(ii) provides rules that apply when the amount of a contingent payment becomes fixed before the payment is due. For purposes of paragraph (b) of this section, if a contingent payment becomes fixed within the 6-month period ending on

the due date of the payment, the payment is treated as a contingent payment even after the payment is fixed. If a contingent payment becomes fixed more than 6 months before the payment is due, the following rules apply to the debt instrument.

(A) *Determining adjustments.* The amount of the adjustment attributable to the contingent payment is equal to the difference between the present value of the amount that is fixed and the present value of the projected amount of the contingent payment. The present value of each amount is determined by discounting the amount from the date the payment is due to the date the payment becomes fixed, using a discount rate equal to the comparable yield on the debt instrument. The adjustment is treated as a positive or negative adjustment, as appropriate, on the date the contingent payment becomes fixed. See paragraph (b)(9)(ii)(G) of this section to determine the timing of the adjustment if all remaining contingent payments on the debt instrument become fixed substantially contemporaneously.

(B) *Payment schedule.* The contingent payment is no longer treated as a contingent payment after the date the amount of the payment becomes fixed. On the date the contingent payment becomes fixed, the projected payment schedule for the debt instrument is modified prospectively to reflect the fixed amount of the payment. Therefore, no adjustment is made under paragraph (b)(3)(iv) of this section when the contingent payment is actually made.

(C) *Accrual period.* Notwithstanding the determination under §1.1272–1(b)(1)(ii) of accrual periods for the debt instrument, an accrual period ends on the day the contingent payment becomes fixed, and a new accrual period begins on the day after the day the contingent payment becomes fixed.

(D) *Adjustments to basis and adjusted issue price.* The amount of any positive adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section increases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument. Similarly, the amount of any negative adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section decreases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument.

(E) *Basis different from adjusted issue price.* If a holder's basis in a debt instrument exceeds the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a negative adjustment on the date the payment becomes fixed. If a holder's basis in a debt instrument is less than the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a positive adjustment on the date the payment becomes fixed.

(F) *Special rule for certain contingent interest payments.* Notwithstanding paragraph (b)(9)(ii)(A) of this section, this paragraph (b)(9)(ii)(F) applies to contingent stated interest payments that are adjusted to compensate for contingencies regarding the reasonableness of the debt instrument's stated rate of interest. For example, this paragraph (b)(9)(ii)(F) applies to a debt instrument that provides for an increase in the stated rate of interest if the credit quality of the issuer or liquidity of the debt instrument deteriorates. Contingent stated interest payments of this type are recognized over the period to which they relate in a reasonable manner.

(G) *Special rule when all contingent payments become fixed.* Notwithstanding paragraph (b)(9)(ii)(A) of this section, if all the remaining contingent payments on a debt instrument become fixed substantially contemporaneously, any positive or negative adjustments on the instrument are taken into account in a reasonable manner over the period to which they relate. For purposes of the preceding sentence, a payment is treated as a fixed payment if all remaining contingencies with respect to the payment are remote or incidental (within the meaning of §1.1275–2(h)).

(H) *Example.* The following example illustrates the provisions of this paragraph (b)(9)(ii). In this example, assume that the instrument described is a debt instrument for Federal income

tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example: Fixed but deferred payments—(i) *Facts.* On December 31, 1996, B, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument matures on December 31, 2002, and provides for a payment of $1,000 at maturity. In addition, on December 31, 1999, and December 31, 2002, the debt instrument provides for payments equal to the excess of the average daily value of an index for the 6-month period ending on September 30 of the preceding year over a specified amount. The debt instrument's comparable yield is 10 percent, compounded annually, and the instrument's projected payment schedule consists of a payment of $250 on December 31, 1999, and a payment of $1,439 on December 31, 2002. B uses annual accrual periods.

(ii) *Interest accrual for 1997.* Based on the projected payment schedule, B includes a total of $100 of daily portions of interest in income in 1997. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1997, is $1,100.

(iii) *Interest accrual for 1998*—(A) *Adjustment.* Based on the projected payment schedule, B would include $110 of total daily portions of interest in income in 1998. However, assume that on September 30, 1998, the payment due on December 31, 1999, fixes at $300, rather than the projected $250. Thus, on September 30, 1998, B has an adjustment equal to the difference between the present value of the $300 fixed amount and the present value of the $250 projected amount of the contingent payment. The present values of the two payments are determined by discounting each payment from the date the payment is due (December 31, 1999) to the date the payment becomes fixed (September 30, 1998), using a discount rate equal to 10 percent, compounded annually. The present value of the fixed payment is $266.30 and the present value of the projected amount of the contingent payment is $221.91. Thus, on September 30, 1998, B has a positive adjustment of $44.39 ($266.30–$221.91).

(B) *Effect of adjustment.* Under paragraph (b)(9)(ii)(C) of this section, B's accrual period ends on September 30, 1998. The daily portions of interest on the debt instrument for the period from January 1, 1998 to September 30, 1998 total $81.51. The adjusted issue price of the debt instrument and B's adjusted basis in the debt instrument are thus increased over this period by $125.90 (the sum of the daily portions of interest of $81.51 and the positive adjustment of $44.39 made at the end of the period) to $1,225.90. For purposes of all future accrual periods, including the new accrual period from October 1, 1998, to December 31, 1998, the debt instrument's projected payment schedule is modified to reflect a fixed payment of $300 on December 31, 1999. Based on the new adjusted issue price of the debt instrument and the new projected payment schedule, the yield on the debt instrument does not change.

(C) *Interest accrual for 1998.* Based on the modified projected payment schedule, $29.56 of interest accrues during the accrual period that ends on December 31, 1998. Because B has no other adjustments during 1998, the $44.39 positive adjustment on September 30, 1998, results in a net positive adjustment for 1998, which is additional interest for that year. Thus, B includes $155.46 ($81.51+$29.56+$44.39) of interest in income in 1998. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1998, is $1,255.46 ($1,225.90 from the end of the prior accrual period plus $29.56 total daily portions for the current accrual period).

(iii) *Timing contingencies.* This paragraph (b)(9)(iii) provides rules for debt instruments that have payments that are contingent as to time.

(A) *Treatment of certain options.* If a taxpayer has an unconditional option to put or call the debt instrument, to exchange the debt instrument for other property, or to extend the maturity date of the debt instrument, the projected payment schedule is determined by using the principles of §1.1272–1(c)(5).

(B) *Other timing contingencies.* [Reserved]

(iv) *Cross-border transactions*—(A) *Allocation of deductions.* For purposes of §1.861–8, the holder of a debt instrument shall treat any deduction or loss treated as an ordinary loss under paragraph (b)(6)(iii)(B) or (b)(8)(ii) of this section as a deduction that is definitely related to the class of gross income to which income from such debt instrument belongs. Accordingly, if a U.S. person holds a debt instrument issued by a related controlled foreign corporation and, pursuant to section 904(d)(3) and the regulations thereunder, any interest accrued by such U.S. person with respect to such debt instrument would be treated as foreign source general limitation income, any deductions relating to a net negative adjustment will reduce the U.S. person's foreign source general limitation

income. The holder shall apply the general rules relating to allocation and apportionment of deductions to any other deduction or loss realized by the holder with respect to the debt instrument.

(B) *Investments in United States real property.* Notwithstanding paragraph (b)(8)(i) of this section, gain on the sale, exchange, or retirement of a debt instrument that is a United States real property interest is treated as gain for purposes of sections 897, 1445, and 6039C.

(v) *Coordination with subchapter M and related provisions.* For purposes of sections 852(c)(2) and 4982 and §1.852–11, any positive adjustment, negative adjustment, income, or loss on a debt instrument that occurs after October 31 of a taxable year is treated in the same manner as foreign currency gain or loss that is attributable to a section 988 transaction.

(vi) *Coordination with section 1092.* A holder treats a negative adjustment and an issuer treats a positive adjustment as a loss with respect to a position in a straddle if the debt instrument is a position in a straddle and the contingency (or any portion of the contingency) to which the adjustment relates would be part of the straddle if entered into as a separate position.

(c) *Method for debt instruments not subject to the noncontingent bond method*—(1) *Applicability.* This paragraph (c) applies to a contingent payment debt instrument (other than a tax-exempt obligation) that has an issue price determined under §1.1274–2. For example, this paragraph (c) generally applies to a contingent payment debt instrument that is issued for nonpublicly traded property.

(2) *Separation into components.* If paragraph (c) of this section applies to a debt instrument (the overall debt instrument), the noncontingent payments are subject to the rules in paragraph (c)(3) of this section, and the contingent payments are accounted for separately under the rules in paragraph (c)(4) of this section.

(3) *Treatment of noncontingent payments.* The noncontingent payments are treated as a separate debt instrument. The issue price of the separate debt instrument is the issue price of the overall debt instrument, determined under §1.1274–2(g). No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273–1(c)) and the de minimis rules of section 1273(a)(3) and §1.1273–1(d) do not apply to the separate debt instrument.

(4) *Treatment of contingent payments*—(i) *In general.* Except as provided in paragraph (c)(4)(iii) of this section, the portion of a contingent payment treated as interest under paragraph (c)(4)(ii) of this section is includible in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the payment is made.

(ii) *Characterization of contingent payments as principal and interest*—(A) *General rule.* A contingent payment is treated as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date. The amount of the payment in excess of the amount treated as principal under the preceding sentence is treated as a payment of interest.

(B) *Test rate.* The test rate used for purposes of paragraph (c)(4)(ii)(A) of this section is the rate that would be the test rate for the overall debt instrument under §1.1274–4 if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is made. However, in the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate determined under the preceding sentence, the test rate is the stated interest rate.

(iii) *Certain delayed contingent payments*—(A) *General rule.* Notwithstanding paragraph (c)(4)(ii) of this section, if a contingent payment becomes fixed more than 6 months before the payment is due, the issuer and holder are treated as if the issuer had issued a separate debt instrument on the date the payment becomes fixed, maturing on the date the payment is due. This separate debt instrument is treated as a debt instrument to which section 1274 applies. The stated principal amount of this separate debt instrument is the

amount of the payment that becomes fixed. An amount equal to the issue price of this debt instrument is characterized as interest or principal under the rules of paragraph (c)(4)(ii) of this section and accounted for as if this amount had been paid by the issuer to the holder on the date that the amount of the payment becomes fixed. To determine the issue price of the separate debt instrument, the payment is discounted at the test rate from the maturity date of the separate debt instrument to the date that the amount of the payment becomes fixed.

(B) *Test rate.* The test rate used for purposes of paragraph (c)(4)(iii)(A) of this section is determined in the same manner as the test rate under paragraph (c)(4)(ii)(B) of this section is determined except that the date the contingent payment is due is used rather than the date the contingent payment is made.

(5) *Basis different from adjusted issue price.* This paragraph (c)(5) provides rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (e.g., a subsequent holder). This paragraph (c)(5), however, does not apply if the holder is reporting income under the installment method of section 453.

(i) *Allocation of basis.* The holder must allocate basis to the noncontingent component (i.e., the right to the noncontingent payments) and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining basis, if any, to the contingent component (i.e., the right to the contingent payments).

(ii) *Noncontingent component.* Any difference between the holder's basis in the noncontingent component and the adjusted issue price of the noncontingent component, and any difference between the holder's basis in a separate debt instrument and the adjusted issue price of the separate debt instrument, is taken into account under the rules for market discount, premium, and acquisition premium that apply to a noncontingent debt instrument.

(iii) *Contingent component.* Amounts received by the holder that are treated as principal payments under paragraph (c)(4)(ii) of this section reduce the holder's basis in the contingent component. If the holder's basis in the contingent component is reduced to zero, any additional principal payments on the contingent component are treated as gain from the sale or exchange of the debt instrument. Any basis remaining on the contingent component on the date the final contingent payment is made increases the holder's adjusted basis in the noncontingent component (or, if there are no remaining noncontingent payments, is treated as loss from the sale or exchange of the debt instrument).

(6) *Treatment of a holder on sale, exchange, or retirement.* This paragraph (c)(6) provides rules for the treatment of a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (c). Under this paragraph (c)(6), the holder must allocate the amount received from the sale, exchange, or retirement of a debt instrument first to the noncontingent component and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining amount received, if any, to the contingent component.

(i) *Amount allocated to the noncontingent component.* The amount allocated to the noncontingent component and any separate debt instruments is treated as an amount realized from the sale, exchange, or retirement of the noncontingent component or separate debt instrument.

(ii) *Amount allocated to the contingent component.* The amount allocated to the contingent component is treated as a contingent payment that is made on the date of the sale, exchange, or retirement and is characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section.

(7) *Examples.* The following examples illustrate the provisions of this paragraph (c). In each example, assume that the instrument described is a debt

instrument for Federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for Federal income tax purposes.

Example 1. Contingent interest payments—(i) *Facts.* A owns Blackacre, unencumbered depreciable real estate. On January 1, 1997, A sells Blackacre to B. As consideration for the sale, B makes a downpayment of $1,000,000 and issues to A a debt instrument that matures on December 31, 2001. The debt instrument provides for a payment of principal at maturity of $5,000,000 and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents B receives from Blackacre in that year. Assume that the debt instrument is not issued in a potentially abusive situation. Assume also that on January 1, 1997, the short-term applicable Federal rate is 5 percent, compounded annually, and the mid-term applicable Federal rate is 6 percent, compounded annually.

(ii) *Determination of issue price.* Under §1.1274–2(g), the issue price of the debt instrument is $3,736,291, which is the present value, as of the issue date, of the $5,000,000 noncontingent payment due at maturity, calculated using a discount rate equal to the mid-term applicable Federal rate. Under §1.1012–1(g)(1), B's basis in Blackacre on January 1, 1997, is $4,736,291 ($1,000,000 down payment plus the $3,736,291 issue price of the debt instrument).

(iii) *Noncontingent payment treated as separate debt instrument.* Under paragraph (c)(3) of this section, the right to the noncontingent payment of principal at maturity is treated as a separate debt instrument. The issue price of this separate debt instrument is $3,736,291 (the issue price of the overall debt instrument). The separate debt instrument has a stated redemption price at maturity of $5,000,000 and, therefore, OID of $1,263,709.

(iv) *Treatment of contingent payments.* Assume that the amount of contingent interest that is fixed and paid on December 31, 1997, is $200,000. Under paragraph (c)(4)(ii) of this section, this payment is treated as consisting of a payment of principal of $190,476, which is the present value of the payment, determined by discounting the payment at the test rate of 5 percent, compounded annually, from the date the payment is made to the issue date. The remainder of the $200,000 payment ($9,524) is treated as interest. The additional amount treated as principal gives B additional basis in Blackacre on December 31, 1997. The portion of the payment treated as interest is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 5 percent, compounded annually, for the contingent payments due on December 31, 1998, and December 31, 1999, and a test rate of 6 percent, compounded annually, for the contingent payments due on December 31, 2000, and December 31, 2001.

Example 2. Fixed but deferred payment—(i) *Facts.* The facts are the same as in paragraph (c)(7) *Example 1* of this section, except that the contingent payment of interest that is fixed on December 31, 1997, is not payable until December 31, 2001, the maturity date.

(ii) *Treatment of deferred contingent payment.* Assume that the amount of the payment that becomes fixed on December 31, 1997, is $200,000. Because this amount is not payable until December 31, 2001, under paragraph (c)(4)(iii) of this section, a separate debt instrument to which section 1274 applies is treated as issued by B on December 31, 1997 (the date the payment is fixed). The maturity date of this separate debt instrument is December 31, 2001 (the date on which the payment is due). The stated principal amount of this separate debt instrument is $200,000, the amount of the payment that becomes fixed. The imputed principal amount of the separate debt instrument is $158,419, which is the present value, as of December 31, 1997, of the $200,000 payment, computed using a discount rate equal to the test rate of the overall debt instrument (6 percent, compounded annually). An amount equal to the issue price of the separate debt instrument is treated as an amount paid on December 31, 1997, and characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section. The amount of the deemed payment characterized as principal is equal to $150,875, which is the present value, as of January 1, 1997 (the issue date of the overall debt instrument), of the deemed payment, computed using a discount rate of 5 percent, compounded annually. The amount of the deemed payment characterized as interest is $7,544 ($158,419 − $150,875), which is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs.

(d) *Rules for tax-exempt obligations*—(1) *In general.* Except as modified by this paragraph (d), the noncontingent bond method described in paragraph (b) of this section applies to a tax-exempt obligation (as defined in section 1275(a)(3)) to which this section applies. Paragraph (d)(2) of this section applies to certain tax-exempt obligations that provide for interest-based payments or revenue-based payments and paragraph (d)(3) of this section applies to all other obligations. Paragraph (d)(4) of this section provides rules for a holder whose basis in a tax-exempt obligation

is different from the adjusted issue price of the obligation.

(2) *Certain tax-exempt obligations with interest-based or revenue-based payments*—(i) *Applicability.* This paragraph (d)(2) applies to a tax-exempt obligation that provides for interest-based payments or revenue-based payments.

(ii) *Interest-based payments.* A tax-exempt obligation provides for interest-based payments if the obligation would otherwise qualify as a variable rate debt instrument under §1.1275–5 except that—

(A) The obligation provides for more than one fixed rate;

(B) The obligation provides for one or more caps, floors, or governors (or similar restrictions) that are fixed as of the issue date;

(C) The interest on the obligation is not compounded or paid at least annually; or

(D) The obligation provides for interest at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, or at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, increased or decreased by a fixed rate.

(iii) *Revenue-based payments.* A tax-exempt obligation provides for revenue-based payments if the obligation—

(A) Is issued to refinance (including a series of refinancings) an obligation (in a series of refinancings, the original obligation), the proceeds of which were used to finance a project or enterprise; and

(B) Would otherwise qualify as a variable rate debt instrument under §1.1275–5 except that it provides for stated interest payments at least annually based on a single fixed percentage of the revenue, value, change in value, or other similar measure of the performance of the refinanced project or enterprise.

(iv) *Modifications to the noncontingent bond method.* If a tax-exempt obligation is subject to this paragraph (d)(2), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Daily portions and net positive adjustments.* The daily portions of interest determined under paragraph (b)(3)(iii) of this section and any net positive adjustment on the obligation are interest for purposes of section 103.

(B) *Net negative adjustments.* A net negative adjustment for a taxable year reduces the amount of tax-exempt interest the holder would otherwise account for on the obligation for the taxable year under paragraph (b)(3)(iii) of this section. If the net negative adjustment exceeds this amount, the excess is a nondeductible, noncapitalizable loss. If a regulated investment company (RIC) within the meaning of section 851 has a net negative adjustment in a taxable year that would be a nondeductible, noncapitalizable loss under the prior sentence, the RIC must use this loss to reduce its tax-exempt interest income on other tax-exempt obligations held during the taxable year.

(C) *Gains.* Any gain recognized on the sale, exchange, or retirement of the obligation is gain from the sale or exchange of the obligation.

(D) *Losses.* Any loss recognized on the sale, exchange, or retirement of the obligation is treated the same as a net negative adjustment under paragraph (d)(2)(iv)(B) of this section.

(E) *Special rule for losses and net negative adjustments.* Notwithstanding paragraphs (d)(2)(iv) (B) and (D) of this section, on the sale, exchange, or retirement of the obligation, the holder may claim a loss from the sale or exchange of the obligation to the extent the holder has not received in cash or property the sum of its original investment in the obligation and any amounts included in income under paragraph (d)(4)(ii) of this section.

(3) *All other tax-exempt obligations*—(i) *Applicability.* This paragraph (d)(3) applies to a tax-exempt obligation that is not subject to paragraph (d)(2) of this section.

(ii) *Modifications to the noncontingent bond method.* If a tax-exempt obligation is subject to this paragraph (d)(3), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Modification to projected payment schedule.* The comparable yield for the

obligation is the greater of the obligation's yield, determined without regard to the contingent payments, and the tax-exempt applicable Federal rate that applies to the obligation. The Internal Revenue Service publishes the tax-exempt applicable Federal rate for each month in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

(B) *Daily portions.* The daily portions of interest determined under paragraph (b)(3)(iii) of this section are interest for purposes of section 103.

(C) *Adjustments.* A net positive adjustment on the obligation is treated as gain to the holder from the sale or exchange of the obligation in the taxable year of the adjustment. A net negative adjustment on the obligation is treated as a loss to the holder from the sale or exchange of the obligation in the taxable year of the adjustment.

(D) *Gains and losses.* Any gain or loss recognized on the sale, exchange, or retirement of the obligation is gain or loss from the sale or exchange of the obligation.

(4) *Basis different from adjusted issue price.* This paragraph (d)(4) provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation. The rules of paragraph (b)(9)(i) of this section do not apply to tax-exempt obligations.

(i) *Basis greater than adjusted issue price.* If the holder's basis in the obligation exceeds the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is not deductible by the holder. However, the holder's basis in the obligation is reduced by the amount allocated to a daily portion of interest on the date the daily portion accrues.

(ii) *Basis less than adjusted issue price.* If the holder's basis in the obligation is less than the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is includible in income by the holder as ordinary income on the date the daily portion accrues. The holder's adjusted basis in the obligation is increased by the amount includible in income by the holder under this paragraph (d)(4)(ii) on the date the daily portion accrues.

(iii) *Premium and discount rules do not apply.* The rules for accruing premium and discount in sections 171, 1276, and 1288 do not apply. Other rules of those sections continue to apply to the extent relevant.

(e) *Amounts treated as interest under this section.* Amounts treated as interest under this section are treated as OID for all purposes of the Internal Revenue Code.

(f) *Effective date.* This section applies to debt instruments issued on or after August 13, 1996.

[T.D. 8674, 61 FR 30143, June 14, 1996, as amended by T.D. 8709, 62 FR 618, Jan. 6, 1997; T.D. 8838, 64 FR 48547, Sept. 7, 1999]

§1.1275–5 Variable rate debt instruments.

(a) *Applicability*—(1) *In general.* This section provides rules for variable rate debt instruments. Except as provided in paragraph (a)(6) of this section, a variable rate debt instrument is a debt instrument that meets the conditions described in paragraphs (a)(2), (3), (4), and (5) of this section. If a debt instrument that provides for a variable rate of interest does not qualify as a variable rate debt instrument, the debt instrument is a contingent payment debt instrument. See §1.1275–4 for the treatment of a contingent payment debt instrument. See §1.1275–6 for a taxpayer's treatment of a variable rate debt instrument and a hedge.

(2) *Principal payments.* The issue price of the debt instrument must not exceed the total noncontingent principal payments by more than an amount equal to the lesser of—

(i) .015 multiplied by the product of the total noncontingent principal payments and the number of complete years to maturity from the issue date (or, in the case of an installment obligation, the weighted average maturity as defined in §1.1273–1(e)(3)); or

(ii) 15 percent of the total noncontingent principal payments.