institution's trade or business, are capital assets. Thus, with respect ot obligations held as capital assets by such a financial institution which are corporate obligations to which section 1232(a)(3) applies, there is ratable inclusion of original issue discount as interest in gross income under paragraph (a) of § 1.1232–3A, and gain on a sale or exchange (including retirement) may be subject to ordinary income treatment under section 582(c) and paragraph (a)(1) of § 1.1232–3.

(c) *Face-amount certificates*—(1) *In general.* For purposes of section 1232, this section and §§ 1.1232–2 through 1.1232–4, the term *other evidence of indebtedness* includes *face amount certificates* as defined in section 2(a)(15) and 4 of the Investment Company Act of 1940 (15 U.S.C. 80a–2 and 80a–4).

(2) *Amounts received in taxable years beginning prior to January 1, 1964.* Amounts received in taxable years beginning prior to January 1, 1964 under face amount certificates which were issued after December 31, 1954, are subject to the limitation on tax under section 72(e)(3). See paragraph (g) of § 1.72–11 (relating to limit on tax attributable to receipt of a lump sum received as an annuity payment). However, section 72(e)(3) does not apply to any such amounts received in taxable years beginning after December 31, 1963.

(3) *Certificates issued after December 31, 1975.* In the case of a face-amount certificate issued after December 31, 1975 (other than such a certificate issued pursuant to a written commitment which was binding on such date and at all times thereafter), the provisions of section 1232(a)(3) (relating to the ratable inclusion of original issue discount in gross income) shall apply. See section 1232–3A(f). For treatment of any increase in basis under section 1232(a)(3)(A) as consideration paid for purposes of computing the investment in the contract under section 72, see § 1.72–6(c)(4).

(d) *Certain deposits in financial institutions.* For purposes of section 1232, this section and §§ 1.1232–2 through 1.1232–4, the term *other evidence of indebtedness* includes certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions. For application of section 1232 to such deposits, see paragraph (e) of § 1.1232–3A. However, section 1232, this section, and §§ 1.1232–2 through 1.1232–4 shall not apply to such deposits made prior to January 1, 1971. For treatment of renewable certificates of deposit, see paragraph (e)(4) of § 1.1232–3A.

[T.D. 7154, 36 FR 25000, Dec. 28, 1971, as amended by T.D. 7311, 39 FR 11880, Apr. 1, 1974; T.D. 7365, 40 FR 27936, July 2, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1232–2 Retirement.

Section 1232(a)(1) provides that any amount received by the holder upon the retirement of an obligation shall be considered as an amount received in exchange therefor. However, section 1232(a)(1) does not apply in the case of an obligation issued before January 1, 1955, which was not issued with interest coupons or in registered form on March 1, 1954. For treatment of gain on an obligation held by certain financial institutions, see section 582(c) and paragraph (a)(1)(iii) of § 1.1232–3.

[T.D. 7154, 36 FR 25000, Dec. 28, 1971]

§ 1.1232–3 Gain upon sale or exchange of obligations issued at a discount after December 31, 1954.

(a) *General rule; sale or exchange*—(1) *Obligations issued by a corporation after May 27, 1969*—(i) *General rule.* Under section 1232(a)(2)(A), in the case of gain realized upon the sale or exchange of an obligation issued at a discount by a corporation after May 27, 1969 (other than an obligation subject to the transitional rule of subparagraph (4) of this paragraph), and held by the taxpayer for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977):

(*a*) If at the time of original issue there was no intention to call the obligation before maturity, such gain shall be considered as long-term capital gain, or

(*b*) If at the time of original issue there was an intention to call the obligation before maturity, such gain shall be considered ordinary income to the extent it does not exceed the excess of:

(*1*) An amount equal to the entire *original issue discount,* over

(*2*) An amount equal to the entire *original issue discount* multiplied by a fraction the numerator of which is the sum of the number of complete months and any fractional part of a month elapsed since the date of original issue and the denominator of which is the number of complete months and any fractional part of a month from the date of original issue to the stated maturity date.

The balance, if any, of the gain shall be considered as long-term capital gain. The amount described in (*2*) of this subdivision (*b*) in effect reduces the amount of original issue discount to be treated as ordinary income under this subdivision (*b*) by the amounts previously includible (regardless of whether included) by all holders (computed, however, as to any holder without regard to any purchase allowance under paragraph (a)(2)(ii) of § 1.1232–3A and without regard to whether any holder purchased at a premium as defined in paragraph (d)(2) of § 1.1232–3).

(ii) *Cross references.* For definition of the terms *original issue discount* and *intention to call before maturity,* see paragraphs (b) (1) and (4) respectively of this section. For definition of the term *date of original issue,* see paragraph (b)(3) of this section. For computation of the number of complete months and any fractional portion of a month, see paragraph (a)(3) of § 1.1232–3A.

(iii) *Effect of section 582(c).* Gain shall not be considered to be long-term capital gain under subdivision (i) of this subparagraph if section 582(c) (relating to treatment of losses and gains on bonds of certain financial institutions) applies.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. On January 1, 1970, A, a calendar-year taxpayer, purchases at original issue for cash of $7,600, M Corporation's 10-year, 5 percent bond which has a stated redemption price at maturity of $10,000. On January 1, 1972, A sells the bond to B, for $9,040. A has previously included $480 of the original issue discount in his gross income (see example (1) of paragraph (d) of § 1.1232–3A) and increased his basis in the bond by that amount to $8,080 (see paragraph (c) of § 1.1232–3A). Thus, if at the time of original issue there was no intention to call the bond before maturity, A's gain of $960 (amount realized, $9,040, less adjusted basis, $8,080) is considered long-term capital gain.

Example 2. (i) Assume the same facts as in example (1), except that at the time of original issue there was an intention to call the bond before maturity. The amount of the entire gain includible by A as ordinary income under subparagraph (1)(i) of this paragraph is determined as follows:

(1) Entire original issue discount (stated redemption price at maturity, $10,000, minus issue price, $7,600)	$2,400
(2) Less: Line (1), $2,400, multiplied by months elapsed since date of original issue, 24, divided by months from such date to stated maturity date, 120	$480
(3) Maximum amount includible by A as ordinary income	$1,920

Since the amount in line (3) is greater than A's gain, $960, A's entire gain is includible as ordinary income.

(ii) On January 1, 1979, B, a calendar-year taxpayer, sells the bond to C for $10,150. Assume that B has included $120 of original issue discount in his gross income for each taxable year he held the bond (see example (2) of paragraph (d) of § 1.1232–3A) and therefore increased his basis by $840 (i.e., $120 each year×7 years) to $9,880. B's gain is therefore $270 (amount realized, $10,150, less basis, $9,880). The amount of such gain includible by B as ordinary income under subparagraph (1)(i) of this paragraph is determined as follows:

(1) Entire original issue discount (as determined in part (i) of this example)	$2,400
(2) Less: Line (1), $2,400, multiplied by months elapsed since date of original issue, 108, divided by months from such date to stated maturity date, 120	$2,160
(3) Maximum amount includible by B as ordinary income	$240

Since the amount in line (3) is less than B's gain, $270, only $240 of B's gain is includible as ordinary income. The remaining portion of B's gain, $30, is considered long-term capital gain.

(3) *Obligations issued by a corporation on or before May 27, 1969, and government obligations.* Under section 1232(a)(2)(B), if gain is realized on the sale or exchange after December 31, 1957, of an obligation held by the taxpayer more than 6 months, and if the obligation either was issued at a discount after December 31, 1954, and on or before May 27, 1969, by a corporation or was issued at a discount after December 31, 1954, by or on behalf of the United States or a foreign country, or a political subdivision of either, then such gain shall be considered ordinary

income to the extent it does not exceed:

(i) An amount equal to the entire *original issue discount,* or

(ii) If at the time of original issue there was no intention to call the obligation before maturity, a portion of the *original issue discount* determined in accordance with paragraph (c) of this section,

And the balance, if any, of the gain shall be considered as long-term capital gain. For the definition of the terms *original issue discount* and *intention to call before maturity,* see paragraphs (b) (1) and (4) respectively of this section. See section 1037(b) and paragraph (b) of §1.1037–1 for special rules which are applicable in applying section 1232(a)(2)(B) and this subparagraph to gain realized on the disposition or redemption of obligations of the United States which were received from the United States in an exchange upon which gain or loss is not recognized because of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)).

(4) *Transitional rule.* Subparagraph (3) of this paragraph (in lieu of subparagraph (1) of this paragraph) shall apply to an obligation issued by a corporation pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter.

(5) *Obligations issued after December 31, 1954, and sold or exchanged before January 1, 1958.* Gain realized upon the sale or exchange before January 1, 1958, of an obligation issued at a discount after December 31, 1954, and held by the taxpayer for more than 6 months, shall be considered ordinary income to the extent it equals a specified portion of the *original issue discount,* and the balance, if any, of the gain shall be considered as long-term capital gain. The term *original issue discount* is defined in paragraph (b)(1) of this section. The computation of the amount of gain which constitutes ordinary income is illustrated in paragraph (c) of this section.

(6) *Obligations issued before January 1, 1955.* Whether gain representing original issue discount realized upon the sale or exchange of obligations issued at a discount before January 1, 1955, is capital gain or ordinary income shall be determined without reference to section 1232.

(b) *Definitions*—(1) *Original issue discount*—(i) *In general.* For purposes of section 1232, the term *original issue discount* means the difference between the issue price and the stated redemption price at maturity. The stated redemption price is determined without regard to optional call dates.

(ii) *De minimis rule.* If the original issue discount is less than one-fourth of 1 percent of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity, then the discount shall be considered to be zero. For example, a 10-year bond with a stated redemption price at maturity of $100 issued at $98 would be regarded as having an original issue discount of zero. Thus, any gain realized by the holder would be a long-term capital gain if the bond was a capital asset in the hands of the holder and held by him for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977). However, if the bond were issued at $97.50 or less, the original issue discount would not be considered zero.

(iii) *Stated redemption price at maturity*—(*a*) Definition. Except as otherwise provided in this subdivision (iii), the term *stated redemption price at maturity* means the amount fixed by the last modification of the purchase agreement, including dividends, interest, and any other amounts, however designated, payable at that time. If any amount based on a fixed rate of simple or compound interest is actually payable or will be treated as constructively received under section 451 and the regulations thereunder either: (*1*) At fixed periodic intervals of one year or less during the entire term of an obligation, or (*2*) except as provided in subdivision (*e*) of this paragraph (b)(1)(iii), at maturity in the case of an obligation with a term of one year or less, any such amount payable at maturity shall not be included in determining the stated redemption price at maturity. For purposes of subdivision (*a*)(*2*) of this paragraph (b)(1)(iii), the term of an obligation shall include any renewal period with respect to which, under the terms of the obligation, the holder may either take action or refrain from taking action which would prevent the actual or constructive receipt of any interest on such obligation until the expiration of any such renewal period. To illustrate this paragraph (b)(1)(iii), assume that a note which promises to pay $1,000 at the end of three years provides for additional amounts labeled as interest to be paid at the rate of $50 at the end of the first year, $50 at the end of the second year, and $120 at the end of the third year. The stated redemption price at maturity will be $1,070 since only $50 of the $120 payable at the end of the third year is based on a fixed rate of simple or compound interest. If, however, the $120 were payable at the end of the second year, so that only $50 in addition to principal would be payable at the end of the third year, then under the rule for serial obligations contained in subparagraph (2)(iv)(*c*) of this paragraph, the $1,000 note is treated as consisting of two series. The first series is treated as maturing at the end of the second year at a stated redemption price of $70. The second series is treated as maturing at the end of the third year at a stated redemption price of $1,000. For the calculation of issue price and the allocation of original issue discount with respect to each such series, see example (3) of subparagraph (2)(iv)(*f*) of this paragraph.

(*b*) *Special rules.* In the case of face -amount certificates, the redemption price at maturity is the price as modified through changes such as extensions of the purchase agreement and includes any dividends which are payable at maturity. In the case of an obligation issued as part of an investment unit consisting of such obligation and an option (which is not excluded by (*c*) of this subdivision (iii)), security, or other property, the term *stated redemption price at maturity* means the amount payable on maturity in respect of the obligation, and does not include any amount payable in respect of the option, security, or other property under a repurchase agreement or option to buy or sell the option, security, or other property. For application of this subdivision to certain deposits in financial institutions, see paragraph (e) of § 1.1232–3A.

(*c*) *Excluded option.* An option is excluded by this subdivision (c) if it is an option to which paragraph (a) of § 1.61–15 applies or if it is an option, referred to in paragraph (a) of § 1.83–7, granted in connection with performance of services to which section 421 does not apply.

(*d*) *Obligation issued in installments.* If an obligation is issued by a corporation under terms whereby the holder makes installment payments, then the stated redemption price for each installment payment shall be computed in a manner consistent with the rules contained in subparagraph (2)(iv) of this paragraph for computing the issue price for each series of a serial obligation. For application of this subdivision (*d*) to certain open account deposit arrangements, see examples (1) and (2) of paragraph (e)(5)(ii) of § 1.1232–3A.

(*e*) *Application of definition.* Subdivision (*a*)(*2*) of this paragraph (b)(1)(iii) shall not apply:

(*1*) For taxable years beginning before September 19, 1979, if for the issuer's last taxable year beginning before September 19, 1978, the rules of § 1.163–4 were properly applied by the issuer, or

(*2*) In the case of an obligation with a term of six months or less held by a nonresident alien individual or foreign corporation, but only for purposes of the appliction of sections 871 and 881.

(iv) *Carryover of original issue discount.* If in pursuance of a plan of reorganization an obligation is received in an exchange for another obligation, and if gain or loss is not recognized in whole or in part on such exchange of obligations by reason, for example, of section 354 or 356, then the obligation received shall be considered to have the same original issue discount as the obligation surrendered reduced by the amount of gain (if any) recognized as ordinary income upon such exchange of obligations, and by the amount of original issue discount with respect to the obligation surrendered which was included as interest income under the ratable inclusion rules of sections 1232(a)(3) and 1.1232–3A. If inclusion as interest of the ratable monthly portion of original issue discount is required under section 1232(a)(3) with respect to the obligation received, see paragraph (a)(2)(iii) of § 1.1232–3A for computation of the ratable monthly portion of original issue discount. For special rules in connection with certain exchanges of U.S. obligations, see section 1037.

(2) *Issue price defined*—(i) *In general.* The term *issue price* in the case of obligations registered with the Securities and Exchange Commission means the initial offering price to the public at which price a substantial amount of such obligations were sold. For this purpose, the term *the public* does not include bond houses and brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers. Ordinarily, the issue price will be the first price at which the obligations were sold to the public, and the issue price will not change if, due to market developments, part of the issue must be sold at a different price. When obligations are privately placed, the issue price of each obligation is the price paid by the first buyer of the particular obligation, irrespective of the issue price of the remainder of the issue. In the case of an obligation issued by a foreign obligor, the issue price shall be increased by the amount, if any, of interest equalization tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of the obligation by the first buyer. In the case of an obligation which is convertible into stock or another obligation, the issue price includes any amount paid in respect of the conversion privilege. However, in the case of an obligation issued as part of an investment unit (as defined in subdivision (ii)(*a*) of this subparagraph), the issue price of the obligation includes only that portion of the initial offering price or price paid by the first buyer properly allocable to the obligation under the rules prescribed in subdivision (ii) of this subparagraph. The terms *initial offering price* and *price paid by the first buyer* include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. Thus, all amounts paid by the purchaser under the purchase agreement or a modification of it are included in the issue price (but in the case of an obligation issued as part of an investment unit, only to the extent allocable to such obligation under subdivision (ii) of this subparagraph), such as amounts paid upon face-amount certificates or installment trust certificates in which the purchaser contracts to make a series of payments which will be returnable to the holder with an increment at a later date.

(ii) *Investment units consisting of obligations and property—(a) In general.* An investment unit, within the meaning of this subdivision (ii) and for purposes of section 1232, consists of an obligation and an option, security, or other property. For purposes of this subparagraph, the initial offering price of an investment unit shall be allocated to the individual elements of the unit on the basis of their respective fair market values. However, if the fair market value of the option, security, or other property is not readily ascertainable (within the meaning of paragraph (c) of § 1.421–6), then the portion of the initial offering price or price paid by the first buyer of the unit which is allocable to the obligation issued as part of such unit shall be ascertained as of the time of acquisition of such unit by reference to the assumed price at which such obligation would have been issued had it been issued apart from such unit. The assumed price of the obligation shall be ascertained by comparison to the yields at which obligations of a similar character which are not issued as part of an investment unit are sold in arm's length transactions, and by adjusting the price of the obligation in question to this yield. The adjustment may be made by subtracting from the face amount of the obligation the total present value of the interest foregone by the purchaser as a result of purchasing the obligation at a lower yield as part of an investment unit. In most cases, assumed price may also be determined in a similar manner through the use of standard bond tables. Any reasonable method may be used in selecting an obligation for comparative purposes. Obligations of the same grade and classification shall be used to the extent possible, and proper regard shall be given, with respect to both the obligation in question and the comparative obligation, to the solvency of the issuer, the nature of the issuer's trade or business, the presence and nature of security for the obligation, the geographic area in which the loan is made, and all other factors relevant to the circumstances. An obligation which is convertible into stock or another obligation must not be used as a comparative obligation (except where the investment unit contains an obligation convertible into stock or another obligation), since such an obligation would not reflect the yield attributable solely to the obligation element of the investment unit.

(*b*) *Agreement as to assumed price.* In the case of an investment unit which is privately placed, the assumed price at which the obligation would have been issued had it been issued apart from such unit may be agreed to by the issuer and the original purchaser of the investment unit in writing on or before the date of purchase. Alternatively, an agreement between the issuer and original purchaser may specify the rate of interest which would have been paid on the obligation if the transaction were one not involving the issuance of options, and an assumed issue price may be determined (in the manner described in (*a*) of this subdivision) from such agreed assumed rate of interest. An assumed price based upon such an agreement between the parties will generally be presumed to be the issue price of the obligation with respect to the issuer, original purchaser, and all subsequent holders: *Provided,* That the agreement was made in arm's length negotiations between parties having adverse interests: *And, provided further,* That such price does not, under the rules stated in (*a*) of this subdivision, appear to be clearly erroneous. An assumed issue price agreed to by the parties as provided herein will not be considered clearly erroneous if it is not less than the face value adjusted (in the manner described in (*a*) of this subdivision) to a yield which is one percentage point greater than the actual rate of interest payable on the obligation. Similarly, if the agreement between the parties specifies an agreed assumed rate of interest (in lieu of an agreed assumed issue price) and such agreed rate is not more than 1 percentage point greater than the actual rate payable on the obligation, an adjusted issue price based upon such agreed assumed rate of interest will not be considered clearly erroneous.

(*c*) *Cross references.* For rules relating to the deductibility by the issuing corporation of bond discount resulting from an allocation under the rule stated in (*a*) of this subdivision, see §§ 1.163–3 and 1.163–4. For rules relating to the basis of obligations and options, securities, or other property acquired in investment units, see § 1.1012–1(d). For rules relating to certain reporting requirements with respect to options acquired in connection with evidences of indebtedness and for the tax treatment of such options, see § 1.61–15, and section 1234 and the regulations thereunder. With respect to the tax consequences to the issuing corporation upon the exercise of options issued in connection with evidences of indebtedness to which this section applies, see section 1032 and the regulations thereunder.

(*d*) *Examples.* The application of the principles set forth in this subdivision (ii) may be illustrated by the following examples in each of which it is assumed that there was no intention to call the note before maturity:

Example 1. M Corporation is a small manufacturer of electronic components located in the southwestern United States. On January 1, 1969, in consideration for the payment of $41,500, M issues to X its unsecured note for $40,000 together with warrants to purchase 3,000 shares of M stock at $10 per share at any time during the term of the note. The note is payable in 4 years and provides for interest at the rate of 5 percent per year, payable semiannually. The fair market values of the note and the warrants are not readily ascertainable. Assume that companies in the same industry as M Corporation, and similarly situated both financially and geographically, are generally able to borrow money on their unsecured notes at an annual interest rate of 6 percent. Using a present value table, the calculation of the issue price of a 5 percent, 4 year, $40,000 note, discounted to yield 6 percent compounded semiannually is made as follows:

(1)	(2)	(3)	(2)×(3)
Semiannual interest period	Amount payable at 5 percent	Factor for present value discounted at 3 percent per period	Present value of payment
1	$1,000	0.9709	$970.90
2	1,000	.9426	942.60
3	1,000	.9151	915.10

(1)	(2)	(3)	(2)×(3)
Semiannual interest period	Amount payable at 5 percent	Factor for present value discounted at 3 percent per period	Present value of payment
4	1,000	.8885	888.50
5	1,000	.8626	862.60
6	1,000	.8375	837.50
7	1,000	.8131	813.10
8	1,000	.7894	789.40
8	40,000	.7804	31,576.00
Total present value of note discounted at 6 percent, compounded semiannually			38,595.70

The same result may be reached through the use of a standard bond table or by the following present value calculation:

Present value of annuity of $1,000 payable over 8 periods at 3 percent per period=1000×7.0197=	$7,019.70
Add: Present value of principal (as calculated above)	31,576.00
Total	$38,595.70

Accordingly, the assumed price at which M's note would have been issued had it been issued without stock purchase warrants, i.e., that portion of the $41,500 price paid by X which is allocable to M's note, is $38,596 (rounded). Since the price payable on redemption of M's note at maturity is $40,000, the original issue discount on M's note is $1,404 ($40,000 minus $38,596). Under the rules stated in §1.163–3, M is entitled to a deduction, to be prorated or amortized over the life of the note, equal to this original issue discount on the note. The excess of the price for the unit over the portion of such price allocable to the note, $2,904 ($41,500 minus $38,596), is allocable to and is the basis of the stock purchase warrants acquired by X in connection with M's note. Upon the exercise of X's warrants, M will be allowed no deduction and will have no income. Upon maturity of the note X will receive $40,000 from M, of which $1,404, the amount of the original issue discount, will be taxable as ordinary income. If X were to transfer the note at its face amount to A 2 years after the issue date, X would realize, under section 1232(a)(2)(B), ordinary income of $702 (one-half of $1,404).

Example 2. (1) On January 1, 1969, N Corporation negotiates with Y, a small business investment company, for a loan in the amount of $51,500 in consideration of which N Corporation issues to Y its unsecured 5-year note for $50,000, together with warrants to purchase 2,000 shares of N stock at $5 per share at any time during the term of the note. The note provides for interest of 6 percent, payable semiannually. The fair market values of the note and warrants are not readily ascertainable. The loan agreement between Y and N contains a provision, agreed to in arms-length bargaining between the parties, that a rate of 7 percent payable semiannually would have been applied to the loan if warrants were not issued as part of the consideration for the loan. The issue price of the note is $47,921 (rounded), determined with the use of a standard bond table, or computed in the manner illustrated in Example 1 or in the following alternative manner:

(1)	(2)	(3)	(4)	(5)	(4)×(5)
Interest period	Interest rate differential	Principal	Interest foregone for period (½%)	Factor for present value discounted at 3½ percent per period	Present value of interest foregone
1	1%(7%-6%)	$50,000	250	0.9662	$241.53
2	1%	50,000	250	.9335	233.38
3	1%	50,000	250	.9019	225.48
4	1%	50,000	250	.8714	217.85
5	1%	50,000	250	.8420	210.50
6	1%	50,000	250	.8135	203.38
7	1%	50,000	250	.7860	196.50
8	1%	50,000	250	.7594	189.85
9	1%	50,000	250	.7337	183.43
10	1%	50,000	250	.7089	177.25
Total present value of interest foregone					$2,079.15
Principal					50,000.00
Less: Total present value of interest foregone					2,079.15
Issue price					47,920.85

The calculation of present value of interest foregone may also be made as follows:

Present value of annuity of $250 discounted for 10 periods at 3½ percent per period=$250×8.3166=$2,079.15.

The total present value of interest foregone, $2,079, is also the original issue discount attributable to the note ($50,000 − $47,921). Under (*b*) of this subdivision, since the agreed assumed rate of interest of 7 percent is not more than 1 percentage point greater than the actual rate payable on the note, determination of the issue price of the note (and original issue discount) based upon such assumed rate will be presumed to be correct and will not be considered clearly erroneous, provided that both N and Y adhere to such determination. Under the rules in §1.163–3, N is entitled to a deduction, to be prorated or amortized over the life of the note, equal to the original issue discount on the note. The excess of the price paid for the unit over the portion of such price allocable to the note, $3,579 ($51,500 − $47,921) is allocable to and is the basis of the stock purchase warrants acquired by Y in connection with N's note. Upon the exercise or sale of the warrants by Y, N will be allowed no deduction and will have no income. Upon maturity of the note Y will receive $50,000 from N, of which $2,079, the amount of the original issue discount, will be taxable as ordinary income. If Y were to transfer the note at its face value to B 2½ years after the issue date, Y would realize, under section 1232(a)(2)(B), ordinary income of $1,039.50 (one-half of $2,079).

(2) Assume that instead of the parties agreeing on an assumed interest rate at which the obligation would have been issued without the warrants, the parties agreed that the obligation at the actual 6 percent rate would have been issued without the warrants at a discounted price of $48,000. In this situation the agreed assumed issue price is presumed to be correct since it is not less than the face value adjusted (in the manner illustrated in part (*1*) of this example) to a yield which is one percentage point greater than the actual rate of interest payable on the obligation ($47,921).

Example 3. O Corporation is a small advertising company located in the northeastern United States. Z is a tax-exempt organization. In consideration for the payment of $60,000, O issues to Z, in a transaction not within the scope of section 503(b), its unsecured 5-year note for $60,000, together with warrants to purchase 6,000 shares of O stock at $10 per share at any time during the term of the note. The note is subject to quarterly amortization at the rate of $3,000 per quarter, and provides for interest on the outstanding unpaid balance at an annual rate of 6 percent payable quarterly (1½ percent per quarter). The fair market values of the notes and warrants are not readily ascertainable. The loan agreement between O and Z contains a recital that if the $60,000 note had been issued without the warrants only $45,000 would have been paid for it. An examination of relevant facts indicates that companies in the same industry as O Corporation, and similarly situated both financially and geographically, are able to borrow money on their unsecured notes at an annual interest cost of 8½ percent payable quarterly (2⅛ percent per quarter). By reference to a present value table, it is found that the present value of O's note discounted to yield 8½ percent compounded quarterly is $56,608 (rounded). The computation is as follows:

(1)	(2)	(3)	(4)	(5)	(6)
Quarterly interest period	Principal payable	Interest payable (1½ percent)	Total amount payable (2)+(3)	Factor for present value discounted at 2⅛ percent per quarter	Present value of total payment (4)×(5)
1	$3,000	$900	$3,900	0.9792	$3,818.88
2	3,000	855	3,855	.9588	3,696.17
3	3,000	810	3,810	.9389	3,577.21
4	3,000	765	3,765	.9193	3,461.16
5	3,000	720	3,720	.9002	3,348.74
6	3,000	675	3,675	.8815	3,239.51
7	3,000	630	3,630	.8631	3,133.05
8	3,000	585	3,585	.8452	3,030.04
9	3,000	540	3,540	.8276	2,929.70
10	3,000	495	3,495	.8104	2,832.35
11	3,000	450	3,450	.7935	2,737.58
12	3,000	405	3,405	.7770	2,645.69
13	3,000	360	3,360	.7608	2,556.29
14	3,000	315	3,315	.7450	2,469.68
15	3,000	270	3,270	.7295	2,385.47
16	3,000	225	3,225	.7143	2,303.62
17	3,000	180	3,180	.6994	2,224.09
18	3,000	135	3,135	.6849	2,147.16
19	3,000	90	3,090	.6706	2,072.15
20	3,000	45	3,045	.6567	1,999.65
Total					56,608.19

This amount ($56,608) is the assumed price at which the note would have been issued had it been issued without stock purchase warrants. The assumed price of $45,000 agreed to by the parties is not presumed to be correct since it is less than the face value adjusted to a yield which is one percentage point greater than the actual rate of interest payable on the obligation. The parties did not have adverse interests in agreeing upon an assumed price (since an excessively large amount of original issue discount would benefit O, the borrower, without adversely affecting Z, an exempt organization which would pay no tax on original issue discount income), and the price agreed to appears to be clearly erroneous when compared to the $56,608 assumed issue price determined under the principles of (*a*) of this subdivision. Since the maturity value of O's note is $60,000, the original issue discount on O's note is $3,392 ($60,000 minus $56,608). Under the rules in §1.163–3, O is entitled to a deduction, to be prorated or amortized over the life of the note, equal to this original issue discount on the note. The excess of the price paid for the unit over the portion of such price allocable to the note, $3,392 ($60,000 minus $56,608), is allocable to and is the basis of the stock purchase warrants acquired by Z in connection with O's note. Upon the exercise or sale of the warrants by Z, O will be allowed no deduction and will have no income.

(iii) *Issuance for property after May 27, 1969*—(*a*) *In general.* Except as provided in (*b*) of this subdivision, if an obligation or an investment unit is issued for property other than money, the issue price of such obligation shall be the stated redemption price at maturity and, therefore, no original issue discount is created as a result of the exchange. However, in such case, there may be an amount treated as interest under section 483. In the case of certain exchanges of obligations of the United States for other such obligations, see section 1037 for the determination of the amount of original issue discount on the obligation acquired in the exchange. For carryover of original issue discount in the case of certain exchanges of obligations, see subparagraph (1)(iv) of this paragraph.

(*b*) *Exceptions for original issue discount.* If an obligation or investment unit is issued for property in an exchange which is not pursuant to a plan of reorganization referred to in (*d*) of this subdivision, and if:

(*1*) The obligation, investment unit, or an element of the investment unit is part of an issue a portion of which is traded on an established securities market, or

(*2*) The property for which such obligation or investment unit is issued is stock or securities which are traded on an established securities market,

then the issue price of the obligation or investment unit shall be the fair market value of the property for which such obligation or investment unit is issued, as determined under (*c*) of this subdivision. Such issue price shall control for purposes of determining the amount realized by the person exchanging the property for the obligation or unit issued and the bases of the property acquired by the holder and issuer.

An obligation which is not traded on an established securities market and which is not part of an issue or investment unit a portion of which is so traded shall not be treated as property described in (*1*) of this (*b*) even though the obligation is convertible into property so traded. For purposes of this (*b*), an obligation, investment unit, or element of an investment unit shall be treated as traded on an established securities market if it is so traded on or within 10 *trading* days after the date it is issued. *Trading* days shall mean those days on which an established securities market is open. For purposes of this subdivision (iii), the term *established securities market* shall have the same meaning as in paragraph (d)(4) of §1.453–3 (relating to limitations on installment method for purchaser evidences of indebtedness payable on demand or readily tradable).

(*c*) *Determination of fair market value in cases to which (b) of this subdivision applies.* In general, for purposes of (*b*) of this subdivision, the fair market value of property for which an obligation or investment unit is issued shall be deemed to be the same as the fair market value of such obligation or investment unit, determined by reference to the fair market value of that portion of the issue, of which such obligation or unit is a part, which is traded on an established securities market. The fair market value of such obligation or unit shall be determined as of the first date after the date of issue (within the meaning of section 1232(b)(3)) that such obligation or unit is traded on an established securities market. If, however, the obligation or investment unit is not part of an issue a portion of which is traded on an established securities market, but the property for which the obligation or investment unit is issued is stock or securities which are traded on an established securities market, the fair market value of such property shall be the fair market value of such stock or securities on the date such obligation or unit is issued for such property. The fair market value of property for purposes of this (*c*) shall be determined as provided in § 20.2031–2 of this chapter (Estate Tax Regulations) but without applying the blockage and other special rules contained in paragraph (e) thereof.

(*d*) *Not in reorganization.* An exchange which is not pursuant to a reorganization referred to in this subdivision (*d*) is an exchange in which the obligation or investment unit is not issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or pursuant to an insolvency reorganization within the meaning of section 371, 373, or 374. Thus, for example, no original issue discount is created on an obligation issued in a recapitalization within the meaning of section 368(a)(1)(E). Similarly, no original issue discount is created on an obligation issued in an exchange, pursuant to a plan of reorganization, to which section 361 applies regardless of the income tax consequences to any person who pursuant to such plan is the ultimate recipient of the obligation. The application of section 351 shall not preclude the creation of original issue discount. For carryover of original issue discount in the case of an exchange of obligations pursuant to a plan of reorganization, see subparagraph (1)(iv) of this paragraph.

(*e*) *Effective date.* Determinations with respect to obligations issued on or before May 27, 1969, or pursuant to a written commitment which was binding on that date and at all times thereafter, shall be made without regard to this subdivision (iii).

(iv) *Serial obligations—(a) In general.* If an issue of obligations which matures serially is issued by a corporation, and if on the basis of the facts and circumstances in such case an independent issue price for each particular maturity can be established, then the obligations with each particular maturity shall be considered a separate series, and the obligations of each such series shall be treated as a separate issue with a separate issue price, maturity date, and stated redemption price at maturity. The ratable monthly portion of original issue discount attributable to each obligation within a particular series shall be determined and ratably included as interest in gross income under the rules of § 1.1232–3A.

(*b*) *Issue price not independently established.* If a separate issue price cannot be established with respect to each series of an issue of obligations which matures serially, the issue price for each obligation of each series shall be its stated redemption price at maturity minus the amount of original issue discount allocated thereto in accordance with (*d*) of this subdivision. The amount of original issue discount so allocated shall be ratably included as interest in gross income under rules of § 1.1232–3A.

(*c*) *Single obligation rule.* If a single corporate obligation provides for payments (other than payments which would not be included in the stated redemption price at maturity under subparagraph (1)(iii) of this paragraph) in two or more installments, the provisions of (*b*) of this subdivision shall be applied by treating such obligation as an issue of obligations consisting of more than one series each of which matures on the due date of each such installment payment.

(*d*) *Allocation of discount.* For purposes of (*b*) and (*c*) of this subdivision, the original issue discount with respect to each series of an issue shall be the total original issue discount for the issue multiplied by a fraction:

(*1*) The numerator of which is the product of (*i*) the stated redemption price of such series and (*ii*) the number of complete years (and any fraction thereof) constituting the period for such series from the date of original issue (as defined in paragraph (b)(3) of this section) to its stated maturity date, and

(*2*) The denominator of which is the sum of the products determined in (*1*) of this subdivision (*d*) with respect to each such series.

If a series consists of more than one obligation, the original issue discount allocated to such series shall be apportioned to such obligations in proportion to the stated redemption price of each. Computations under this subdivision (*d*) may be made using periods other than years, such as, for example, months or periods of 3 months.

(*e*) *Effective date.* The provisions of this subdivision (iv) shall apply with respect to corporate obligations issued after July 22, 1971. However, no inference shall be drawn from the preceding sentence with respect to serial obligations issued prior to such date.

(*f*) *Examples.* The provisions of this subdivision (iv) may be illustrated by the following examples:

Example 1. On January 1, 1972, P Corporation issued a note with a total face value of $100,000 to B for cash of $94,000. The terms of the note provide that $50,000 is payable on December 31, 1973, and the other $50,000 on December 31, 1975. Each payment is treated as the stated redemption price of a series, and the total original issue discount with respect to the note, $6,000, is allocated to each such series as follows:

Year of maturity	1973	1975	Total
(1) Stated redemption price	$50,000	$50,000	
(2) Multiply by years outstanding	2	4	
(3) Product of bond years	$100,000	$200,000	
(4) Sum of products	....	....	$300,000
(5) Fractional portion of discount	$100,000	$200,000	
	$300,000	$300,000	
(6) Multiply line (5) by discount for entire issue	$6,000	$6,000	
(7) Discount for each series	$2,000	$4,000	
(8) Issue price (line (1), minus line (7))	$48,000	$46,000	

Example 2. Assume the same facts as in example (1) except that a separate note is issued for each payment. The result is the same as in example (1).

Example 3. On January 1, 1971, Y Bank, a corporation, issues a note to C for $1,000 cash. The terms of the note provide that $50 will be paid at the end of the first year, $120 at the end of the second year, and $1,050 at the end of the third year. Under (*c*) of this subdivision (iv), the $1,000 note is treated as consisting of two series, the first of which matures at the end of the second year, and the second of which matures at the end of the third year. The issue price and the allocation of original issue discount with respect to each series is computed as follows:

Year of maturity	1972	1973	Total
(1) Stated redemption price	$70	$1,000	
(2) Multiply by years outstanding	2	3	
(3) Product of bond years	$140	$3,000	
(4) Sum of products	....	....	$3,140
(5) Fractional portion of discount	$140	$3,000	
	$3,140	$3,140	
(6) Multiply line (5) by discount for entire issue	$70	$70	
(7) Discount for each series	$3.12	$66.88	
(8) Issue price (line 1 minus line (7))	$66.88	$933.12	

(3) *Date of original issue.* In the case of issues of obligations which are registered with the Securities and Exchange Commission, the term *date of original issue* means the date on which the issue was first sold to the public at the issue price. In the case of issues which are privately placed, the term *date of original issue* means the date on which each obligation was sold to the original purchaser.

(4) *Intention to call before maturity*—(i) *Meaning of term.* For purposes of section 1232, the term *intention to call the bond or other evidence of indebtedness before maturity* means an understanding between (*a*) the issuing corporation (such corporation is hereinafter referred to as the *issuer*), and (*b*) the original purchaser of such obligation (or, in the case of obligations constituting part of an issue, any of the original purchasers of such obligations) that the issuer will redeem the obligation before maturity. For purposes of this subparagraph, the term *original purchaser* does not include persons or organizations acting in the capacity of underwriters or dealers, who purchased the obligation for resale in the ordinary course of their trade or business. It is not necessary that the issuer's intention to call the obligation before maturity be communicated directly to

the original purchaser by the issuer. The understanding to call before maturity need not be unconditional; it may, for example, be dependent upon the financial condition of the issuer on the proposed early call date.

(ii) *Proof of intent—(a) In general.* Ordinarily, the existence or nonexistance of an understanding at the time of original issue that the obligation will be redeemed before maturity shall be determined by an examination of all of the circumstances under which the obligation was issued and held. The fact that the obligation is issued with provisions on its face giving the issuer the privilege of redeeming the obligation before maturity is not determinative of an intention to call before maturity; likewise, the absence of such provision is not determinative of the absence of an intention to call before maturity. However, such provision, or the absence of such provision, is one of the circumstances to be given consideration along with other factors in determining whether an understanding existed. If the obligation was part of an issue registered with the Securities and Exchange Commission and was sold to the public (whether or not sold directly to the public by the obligor) without representation to the public that the obligor intends to call the obligation before maturity, there shall be a presumption that no intention to call the obligation before maturity was in existence at the time of original issue. The existence of a provision on the face of an obligation giving the issuer the privilege of redeeming the obligation before maturity shall not in and of itself overcome the presumption set forth in the preceding sentence.

(*b*) *Circumstances indicating absence of understanding.* Examples of circumstances which would be evidence that there was no understanding at the time of original issue to redeem the obligation before maturity are:

(*1*) The issue price and term of the obligation appear to be reasonable, taking into account the interest rate, if any, on the obligation, for a corporation in the financial condition of the issuer at the time of issue.

(*2*) The original purchaser and the issuer are not related within the meaning of section 267(b) and have not engaged in transactions with each other (other than concerning the obligation).

(*3*) The original purchaser is not related within the meaning of section 267(b) to any of the officers or directors of the issuer, and he has not engaged in transactions with such officers or directors (other than concerning the obligation).

(*4*) The officers and directors of the issuer at the time of issue of the obligation are different from those in control at the time the obligation is called or the taxpayer disposes of it.

(c) *Gain treated as ordinary income in certain cases; computation.* The amount of gain treated as ordinary income under paragraph (a) (3)(ii) or (5) of this section is computed by multiplying the original issue discount by a fraction, the numerator of which is the number of full months the obligation was held by the holder and the denominator of which is the number of full months from the date of original issue to the date specified as the redemption date at maturity. (See paragraph (b)(3) of this section for definition of *date of original issue.*) The period that the obligation was held by the taxpayer shall include any period that it was held by another person if, under chapter 1 of the Code, for the purpose of determining gain or loss from a sale or exchange, the obligation has the same basis, in whole or in part, in the hands of the taxpayer as it would have in the hands of such other person. This computation is illustrated by the following examples:

Example 1. An individual purchases a 10-year, 3-percent coupon bond for $900 on original issue on February 1, 1955, and sells it on February 20, 1960, for $940. The redemption price is $1,000. At the time of original issue, there was no intention to call the bond before maturity. The bond has been held by the taxpayer for 60 full months. (The additional days amounting to less than a full month are not taken into account.) The number of complete months from date of issue to date of maturity is 120 (10 years). The fraction 60/120 multiplied by the discount of $100 is equal to $50, which represents the proportionate part of the original issue discount attributable to the period of ownership by the taxpayer. Accordingly, any part of the gain up to $50 will be treated as ordinary income. Therefore, in this case the entire gain of $40 is treated as ordinary income.

Example 2. Assume the same facts in the preceding example, except that the selling price of the bond is $970. In this case $50 of the gain of $70 is treated as ordinary income and the balance of $20 is treated as long-term capital gain.

Example 3. Assume the same facts as in example (1), except that the selling price of the bond is $800. In this case, the individual has a long-term capital loss of $100.

Example 4. Assume the same facts as in example (1), except that the bond is purchased by the second holder February 1, 1960, for $800. The second holder keeps it to the maturity date (February 1, 1965) when it is redeemed for $1,000. Since that holder has held the bond for 60 full months, he will, upon redemption, have $50 in ordinary income and $150 in long-term capital gain.

(d) *Exceptions to the general rule*—(1) *In general.* Section 1232(a)(2)(C) provides that section 1232(a)(2) does not apply (i) to obligations the interest on which is excluded from gross income under section 103 (relating to certain government obligations), or (ii) to any holder who purchases an obligation at a premium.

(2) *Premium.* For purposes of section 1232, this section, and § 1.1232–3A, *premium* means a purchase price which exceeds the stated redemption price of an obligation at its maturity. For purposes of the preceding sentence, if an obligation is acquired as part of an investment unit consisting of an option, security, or other property and an obligation, the purchase price of the obligation is that portion of the price paid or payable for the unit which is allocable to the obligation. The price paid for the unit shall be allocated to the individual elements of the unit on the basis of their respective fair market values. However, if the fair market value of the option, security, or other property is not readily ascertainable (within the meaning of paragraph (c) of § 1.421–6), then the price paid for the unit shall be allocated in accordance with the rules under paragraph (b)(2)(ii) of this section for allocating the initial offering price of an investment unit to its elements. If, under chapter 1 of the Code, the basis of an obligation in the hands of the holder is the same, in whole or in part, for the purposes of determining gain or loss from a sale or exchange, as the basis of the obligation in the hands of another person who purchased the obligation at a premium, then the holder shall be considered to have purchased the obligation at a premium. Thus, the donee of an obligation purchased at a premium by the doner will be considered a holder who purchased the obligation at a premium.

(e) *Amounts previously includible in income.* Nothing in section 1232(a)(2) shall require the inclusion of any amount previously includible in gross income. Thus, if an amount was previously includible in a taxpayer's income on account of obligations issued at a discount and redeemable for fixed amounts increasing at stated intervals, or, under section 818(b) (relating to accrual of discount on bonds and other evidences of indebtedness held by life insurance companies), such amount is not again includible in the taxpayer's gross income under section 1232(a)(2). For example, amounts includible in gross income by a cash receipts and disbursements method taxpayer who has made an election under section 454 (a) or (c) (relating to accounting rules for certain obligations issued at a discount to which section 1232(a)(3) does not apply) are not includible in gross income under section 1232(a)(2). In the case of a gain which would include, under section 1232(a)(2), an amount considered to be ordinary income and a further amount considered long-term capital gain, any amount to which this paragraph applies is first used to offset the amount considered ordinary income. For example, on January 1, 1955, A purchases a 10-year bond which is redeemable for fixed amounts increasing at stated intervals. At the time of original issue, there was no intention to call the bond before maturity. The purchase price of the bond is $75, which is also the issue price. The stated redemption price at maturity of the bond is $100. A elects to treat the annual increase in the redemption price of the bond as income pursuant to section 454(a). On January 1, 1960, A sells the bond for $90. The total stated increase in the redemption price of the bond which A has reported annually as income for the taxable years 1955 through 1959 is $7. The portion of the original issue discount of $25 attributable to this period is $12.50, computed as follows:

60 (months bond is held by A)/120 (months from date of original issue to redemption date)×$25 (original issue discount)

However, $7, which represents the annual stated increase taken into income, is offset against the amount of $12.50, leaving $5.50 of the gain from the sale to be treated as ordinary income.

(f) *Recordkeeping requirements.* In the case of any obligation held by a taxpayer which was issued at an original issue discount after December 31, 1954, the taxpayer shall keep a record of the issue price and issue date upon or with each obligation (if known to or reasonably ascertainable by him). If the obligation held by the taxpayer is an obligation of the United States received from the United States in an exchange upon which gain or loss is not recognized because of section 1037 (a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)), the taxpayer shall keep sufficient records to determine the issue price of such obligation for purposes of applying section 1037(b) and paragraphs (a) and (b) of § 1.1037–1 upon the disposition or redemption of such obligation. The issuer (or in the case of obligations first sold to the public through an underwriter or wholesaler, the underwriter or wholesaler) shall mark the issue price and issue date upon every obligation which is issued at an original issue discount after September 26, 1957, but only if the period between the date of original issue (as defined in paragraph (b)(3) of this section) and the stated maturity date is more than 6 months.

[T.D. 6500, 25 FR 12008, Nov. 26, 1960, as amended by T.D. 6984, 33 FR 19176, Dec. 21, 1968; T.D. 7154, 36 FR 25000, Dec. 28, 1971; 37 FR 527, Jan. 13, 1972; T.D. 7213, 37 FR 21992, Oct. 18, 1972; 37 FR 22863, Oct. 26, 1972; T.D. 7663, 44 FR 76782, Dec. 28, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.1232–3A Inclusion as interest of original issue discount on certain obligations issued after May 27, 1969.

(a) *Ratable inclusion as interest*—(1) *General rule.* Under section 1232(a)(3), the holder of any obligation issued by a corporation after May 27, 1969 (other than an obligation issued by or on behalf of the United States or a foreign country, or a political subdivision of either) shall include as interest in his gross income an amount equal to the ratable monthly portion of original issue discount multiplied by the sum of the number of complete months and any fractional part of a month such holder held the obligation during the taxable year. For increase in basis for amounts included as interest in gross income pursuant to this paragraph, see paragraph (c) of this section. For requirements for reporting original issue discount, see section 6049(a) and the regulations thereunder.

(2) *Ratable monthly portion of original issue discount*—(i) *General rule.* Except when subdivision (ii) of this subparagraph applies, the term *ratable monthly portion of original issue discount* means an amount equal to the original issue discount divided by the sum of the number of complete months (plus any fractional part of a month) beginning on the date of original issue and ending the day before the stated maturity date of such obligation.

(ii) *Reduction for purchase allowance.* With respect to an obligation which has been acquired by purchase (within the meaning of subparagraph (4) of this paragraph), the term *ratable monthly portion of original issue discount* means the lesser of the amount determined under subdivision (i) of this subparagraph or an amount equal to:

(*a*) The excess (if any) of the stated redemption price of the obligation at maturity over its cost to the purchaser divided by

(*b*) The sum of the number of complete months (plus any fractional part of a month) beginning on the date of such purchase and ending the day before the stated maturity date of such obligation.

The amount of the ratable monthly portion within the meaning of this subdivision reflects a purchase allowance provided under section 1232(a)(3)(B) where a purchase is made at a price in excess of the sum of the issue price plus the portion of original issue discount previously includible (regardless of whether included) in the gross income of all previous holders (computed, however, as to such previous holders without regard to any purchase allowance under this subdivision and