

transaction (for example, under section 1256), as of the date that gain or loss is realized, any unrecognized loss in any other position of the conversion transaction that is not disposed of, terminated, or treated as sold under any provision of the Code or regulations thereunder within 14 days of and within the same taxable year as the realization event.

(d) *Examples.* These examples illustrate this section:

Example 1. Identified netting transaction with simultaneous actual dispositions. (i) On December 1, 1995, A purchases 1,000 shares of XYZ stock for \$100,000 and enters into a forward contract to sell 1,000 shares of XYZ stock on November 30, 1997, for \$110,000. The XYZ stock is actively traded as defined in § 1.1092(d)-1(a) and is a capital asset in A's hands. A maintains books and records on which, on December 1, 1995, it identifies the two positions as all the positions of a single conversion transaction. A owns no other XYZ stock. On December 1, 1996, when the applicable imputed income amount for the transaction is \$7,000, A sells the 1,000 shares of XYZ stock for \$95,000. On the same day, A terminates its forward contract with its counterparty, receiving \$10,200. No dividends were received on the stock during the time it was part of the conversion transaction.

(ii) The XYZ stock and forward contract are positions of a conversion transaction. Under section 1258(c)(1), substantially all of A's expected return from the overall transaction is attributable to the time value of the net investment in the transaction. Under section 1258(c)(2)(B), the transaction is an applicable straddle as defined in section 1258(d)(1).

(iii) A disposed of or terminated all the positions of the conversion transaction within 14 days and within the same taxable year as required by paragraph (b)(1) of this section. The transaction is an identified netting transaction because it meets the identification requirement of paragraph (b)(2) of this section. Solely for purposes of section 1258(a), the \$5,000 loss realized (\$100,000 basis less \$95,000 amount realized) on the disposition of the XYZ stock is netted against the \$10,200 gain recognized on the disposition of the forward contract. Thus, the net gain from the conversion transaction for purposes of section 1258(a) is \$5,200 (\$10,200 gain less \$5,000 loss). Only the \$5,200 net gain is recharacterized as ordinary income under section 1258(a) even though the applicable imputed income amount is \$7,000. For Federal tax purposes other than section 1258(a), A has recognized a \$10,200 gain on the disposition of the forward contract (\$5,200 of which is treated as ordinary income) and realized a

separate \$5,000 loss on the sale of the XYZ stock.

Example 2. Identified netting transaction with built-in loss. (i) The facts are the same as in *Example 1*, except that A had purchased the XYZ stock for \$104,000 on May 15, 1995. The XYZ stock had a fair market value of \$100,000 on December 1, 1995, the date it became part of a conversion transaction.

(ii) The results are the same as in *Example 1*, except that A has built-in loss (in addition to the \$5,000 loss that arose economically during the period of the conversion transaction), as defined in section 1258(d)(3)(B), of \$4,000 on the XYZ stock. That \$4,000 built-in loss is not netted against the \$10,200 gain on the forward contract for purposes of section 1258(a). Thus, the net gain from the conversion transaction for purposes of section 1258(a) is \$5,200, the same as in *Example 1*. The \$4,000 built-in loss is recognized and has a character determined without regard to section 1258.

(e) *Effective date and transition rule—*
(1) *In general.* These regulations are effective for conversion transactions that are outstanding on or after December 21, 1995.

(2) *Transition rule for identification requirements.* In the case of a conversion transaction entered into before February 20, 1996, paragraph (b)(2) of this section is treated as satisfied if the identification is made before the close of business on February 20, 1996.

[T.D. 8649, 60 FR 66084, Dec. 21, 1995]

§ 1.1271-0 Original issue discount; effective date; table of contents.

(a) *Effective date.* Except as otherwise provided, §§ 1.1271-1 through 1.1275-5 apply to debt instruments issued on or after April 4, 1994. Taxpayers, however, may rely on these sections (as contained in 26 CFR part 1 revised April 1, 1996) for debt instruments issued after December 21, 1992, and before April 4, 1994.

(b) *Table of contents.* This section lists captioned paragraphs contained in §§ 1.1271-1 through 1.1275-7T.

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

- (a) Intention to call before maturity.
 - (1) In general.
 - (2) Exceptions.
- (b) Short-term obligations.
 - (1) In general.
 - (2) Method of making elections.
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§ 1.1272-1 Current inclusion of OID in income.

- (a) Overview.
 - (1) In general.
 - (2) Debt instruments not subject to OID inclusion rules.
- (b) Accrual of OID.
 - (1) Constant yield method.
 - (2) Exceptions.
 - (3) Modifications.
 - (4) Special rules for determining the OID allocable to an accrual period.
- (c) Yield and maturity of certain debt instruments subject to contingencies.
 - (1) Applicability.
 - (2) Payment schedule that is significantly more likely than not to occur.
 - (3) Mandatory sinking fund provision.
 - (4) Consistency rule. [Reserved]
 - (5) Treatment of certain options.
 - (6) Subsequent adjustments.
 - (7) Effective date.
- (d) Certain debt instruments that provide for a fixed yield.
- (e) Convertible debt instruments.
- (f) Special rules to determine whether a debt instrument is a short-term obligation.
 - (1) Counting of either the issue date or maturity date.
 - (2) Coordination with paragraph (c) of this section for certain sections of the Internal Revenue Code.
- (g) Basis adjustment.
- (h) Debt instruments denominated in a currency other than the U.S. dollar.
- (i) [Reserved]
- (j) Examples.

§ 1.1272-2 Treatment of debt instruments purchased at a premium.

- (a) In general.
- (b) Definitions and special rules.
 - (1) Purchase.
 - (2) Premium.
 - (3) Acquisition premium.
 - (4) Acquisition premium fraction.
 - (5) Election to accrue discount on a constant yield basis.
 - (6) Special rules for determining basis.
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§ 1.1272-3 Election by a holder to treat all interest on a debt instrument as OID.

- (a) Election.
- (b) Scope of election.
 - (1) In general.
 - (2) Exceptions, limitations, and special rules.
- (c) Mechanics of the constant yield method.
 - (1) In general.
 - (2) Special rules to determine adjusted basis.
- (d) Time and manner of making the election.
- (e) Revocation of election.
- (f) Effective date.

§ 1.1273-1 Definition of OID.

- (a) In general.
- (b) Stated redemption price at maturity.
- (c) Qualified stated interest.
 - (1) Definition.
 - (2) Debt instruments subject to contingencies.
 - (3) Variable rate debt instrument.
 - (4) Stated interest in excess of qualified stated interest.
 - (5) Short-term obligations.
- (d) De minimis OID.
 - (1) In general.
 - (2) De minimis amount.
 - (3) Installment obligations.
 - (4) Special rule for interest holidays, teaser rates, and other interest shortfalls.
 - (5) Treatment of de minimis OID by holders.
- (e) Definitions.
 - (1) Installment obligation.
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- (f) Examples.

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

- (a) Debt instruments issued for money.
 - (1) Issue price.
 - (2) Issue date.
- (b) Publicly traded debt instruments issued for property.
 - (1) Issue price.
 - (2) Issue date.
- (c) Debt instruments issued for publicly traded property.
 - (1) Issue price.
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 - (3) Other debt instruments.
- (d) Other debt instruments.
 - (1) Issue price.
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- (e) Special rule for certain sales to bond houses, brokers, or similar persons.
- (f) Traded on an established market (publicly traded).
 - (1) In general.
 - (2) Exchange listed property.
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 - (5) Readily quotable debt instruments.
 - (6) Effect of certain temporary restrictions on trading.
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- (g) Treatment of certain cash payments incident to lending transactions.
 - (1) Applicability.
 - (2) Payments from borrower to lender.
 - (3) Payments from lender to borrower.
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 - (5) Examples.
 - (h) Investment units.
 - (1) In general.
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- (i) [Reserved]
- (j) Convertible debt instruments.
- (k) Below-market loans subject to section 7872(b).

- (l) [Reserved]
- (m) Treatment of amounts representing pre-issuance accrued interest.
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 - (2) Exclusion of pre-issuance accrued interest from issue price.
 - (3) Example.

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- (a) In general.
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 - (2) Exceptions under sections 1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1).
 - (3) Other exceptions to section 1274.
- (c) Examples.

§ 1.1274-2 Issue price of debt instruments to which section 1274 applies.

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- (b) Issue price.
 - (1) Debt instruments that provide for adequate stated interest; stated principal amount.
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- (c) Determination of whether a debt instrument provides for adequate stated interest.
 - (1) In general.
 - (2) Determination of present value.
 - (d) Treatment of certain options.
 - (e) Mandatory sinking funds.
 - (f) Treatment of variable rate debt instruments.
 - (1) Stated interest at a qualified floating rate.
 - (2) Stated interest at a single objective rate.
 - (g) Treatment of contingent payment debt instruments.
 - (h) Examples.
 - (i) [Reserved]
 - (j) Special rules for tax-exempt obligations.
 - (1) Certain variable rate debt instruments.
 - (2) Contingent payment debt instruments.
 - (3) Effective date.

§ 1.1274-3 Potentially abusive situations defined.

- (a) In general.
- (b) Operating rules.
 - (1) Debt instrument exchanged for non-recourse financing.
 - (2) Nonrecourse debt with substantial down payment.
 - (3) Clearly excessive interest.

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- (c) Other situations to be specified by Commissioner.
- (d) Consistency rule.

§ 1.1274-4 Test rate.

- (a) Determination of test rate of interest.
 - (1) In general.
 - (2) Test rate for certain debt instruments.
 - (b) Applicable Federal rate.
 - (c) Special rules to determine the term of a debt instrument for purposes of determining the applicable Federal rate.
 - (1) Installment obligations.
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 - (3) Counting of either the issue date or the maturity date.
 - (4) Certain debt instruments that provide for principal payments uncertain as to time.
 - (d) Foreign currency loans.
 - (e) Examples.

§ 1.1274-5 Assumptions.

- (a) In general.
- (b) Modifications of debt instruments.
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§ 1.1274A-1 Special rules for certain transactions where stated principal amount does not exceed \$2,800,000.

- (a) In general.
- (b) Rules for both qualified and cash method debt instruments.
 - (1) Sale-leaseback transactions.
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 - (3) Aggregation of transactions.
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 - (2) Successors of electing parties.
 - (3) Modified debt instrument.
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(4) *Cross-references for reopening and aggregation rules.*

(g) Debt instruments issued by a natural person.

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(2) *Reopenings of Treasury securities.*

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(2) Definition of pro rata prepayment.

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(5) Consistency rule.

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(j) Treatment of certain modifications.

(k) *Reopenings.*

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(2) *Definitions.*

(3) *Qualified reopening.*

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(3) Exceptions.

(d) Application to foreign issuers and U.S. issuers of foreign-targeted debt instruments.

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§ 1.1275-4 Contingent payment debt instruments.

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(2) Exceptions.

(3) Insolvency and default.

(4) Convertible debt instruments.

(5) Remote and incidental contingencies.

(b) Noncontingent bond method.

(1) Applicability.

(2) In general.

(3) Description of method.

(4) Comparable yield and projected payment schedule.

(5) Qualified stated interest.

(6) Adjustments.

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(2) Separation into components.

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(4) Treatment of contingent payments.

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(2) Principal payments.

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(2) Other objective rates to be specified by Commissioner.

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(d) Examples.

(e) Qualified stated interest and OID with respect to a variable rate debt instrument.

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

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

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§ 1.1275-6 Integration of qualifying debt instruments.

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(b) Definitions.

(1) Qualifying debt instrument.

(2) Section 1.1275-6 hedge.

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(1) Legging into.

(2) Legging out.

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(1) General rule.

(2) Issue date.

(3) Term.

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(8) Source of interest income and allocation of expense.

(9) Effectively connected income.

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(b) Applicability.

(1) In general.

(2) Exceptions.

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(4) Inflation-adjusted principal amount.

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(2) Applicability.

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(5) Example.

(e) Discount bond method.

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(2) Adjusted basis.

(3) Subsequent holders.

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(h) Effective date.

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

(a) *Intention to call before maturity*—(1) *In general.* For purposes of section 1271(a)(2), all or a portion of gain realized on a sale or exchange of a debt instrument to which section 1271 applies is treated as interest income if there was an intention to call the debt instrument before maturity. An intention to call a debt instrument before