

maturity means a written or oral agreement or understanding not provided for in the debt instrument between the issuer and the original holder of the debt instrument that the issuer will redeem the debt instrument before maturity. In the case of debt instruments that are part of an issue, the agreement or understanding must be between the issuer and the original holders of a substantial amount of the debt instruments in the issue. An intention to call before maturity can exist even if the intention is conditional (e.g., the issuer's decision to call depends on the financial condition of the issuer on the potential call date) or is not legally binding. For purposes of this section, original holder means the first holder (other than an underwriter or dealer that purchased the debt instrument for resale in the ordinary course of its trade or business).

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

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

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

(iii) A debt instrument sold pursuant to a private placement memorandum that is distributed to more than ten offerees and that is subject to the sanctions of section 12(2) of the Securities Act of 1933 (15 U.S.C. 77l) or the prohibitions of section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j).

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

(2) *Method of making elections.* Elections to accrue on a constant yield basis under sections 1271 (a)(3)(E) and (a)(4)(D) are made on an obligation-by-

obligation basis by reporting the transaction on the basis of daily compounding on the taxpayer's timely filed Federal income tax return for the year of the sale or exchange. These elections are irrevocable.

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

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§ 1.1272-1 Current inclusion of OID in income.

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

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

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

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield to maturity or yield of a debt instrument is the discount rate that, when used in computing the present value of all principal and interest payments to be made under the debt instrument, produces an amount equal to the issue price of the debt instrument. The yield must be constant over the term of the debt instrument and, when expressed as a percentage, must be calculated to

at least two decimal places. See paragraph (c) of this section for rules relating to the yield of certain debt instruments subject to contingencies.

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

(iii) *Step three: Determine the OID allocable to each accrual period.* Except as provided in paragraph (b)(4) of this section, the OID allocable to an accrual period equals the product of the adjusted issue price of the debt instrument (as defined in § 1.1275-1(b)) at the beginning of the accrual period and the yield of the debt instrument, less the amount of any qualified stated interest allocable to the accrual period. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. *Example 1* in paragraph (j) of this section provides a formula for converting a yield based upon an accrual period of one length to an equivalent yield based upon an accrual period of a different length.

(iv) *Step four: Determine the daily portions of OID.* The daily portions of OID are determined by allocating to each day in an accrual period the ratable portion of the OID allocable to the accrual period. The holder of the debt instrument includes in income the daily portions of OID for each day during the taxable year on which the holder held the debt instrument.

(2) *Exceptions.* Paragraph (b)(1) of this section does not apply to—

(i) 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);

(ii) A debt instrument that provides for contingent payments, other than a debt instrument described in paragraph (c) or (d) of this section or except as provided in § 1.1275-4; or

(iii) A variable rate debt instrument to which § 1.1275-5 applies, except as provided in § 1.1275-5.

(3) *Modifications.* The amount of OID includible in income by a holder under paragraph (b)(1) of this section is adjusted if—

(i) The holder purchased the debt instrument at a premium or an acquisition premium (within the meaning of § 1.1272-2); or

(ii) The holder made an election for the debt instrument under § 1.1272-3 to treat all interest as OID.

(4) *Special rules for determining the OID allocable to an accrual period.* The following rules apply to determine the OID allocable to an accrual period under paragraph (b)(1)(iii) of this section.

(i) *Unpaid qualified stated interest allocable to an accrual period.* In determining the OID allocable to an accrual period, if an interval between payments of qualified stated interest contains more than 1 accrual period—

(A) The amount of qualified stated interest payable at the end of the interval (including any qualified stated interest that is payable on the first day of the accrual period immediately following the interval) is allocated on a pro rata basis to each accrual period in the interval; and

(B) The adjusted issue price at the beginning of each accrual period in the interval must be increased by the amount of any qualified stated interest that has accrued prior to the first day of the accrual period but that is not payable until the end of the interval. See *Example 2* of paragraph (j) of this section for an example illustrating the rules in this paragraph (b)(4)(i).

(ii) *Final accrual period.* The OID allocable to the final accrual period is the difference between the amount payable at maturity (other than a payment of qualified stated interest) and the adjusted issue price at the beginning of the final accrual period.

(iii) *Initial short accrual period.* If all accrual periods are of equal length, except for either an initial shorter accrual period or an initial and a final shorter accrual period, the amount of OID allocable to the initial accrual period may be computed using any reasonable method. See *Example 3* in paragraph (j) of this section.

(iv) *Payment on first day of an accrual period.* The adjusted issue price at the beginning of an accrual period is reduced by the amount of any payment (other than a payment of qualified stated interest) that is made on the first day of the accrual period.

(c) *Yield and maturity of certain debt instruments subject to contingencies—(1) Applicability.* This paragraph (c) provides rules to determine the yield and maturity of certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and the debt instrument is subject to paragraph (c)(2), (3), or (5) of this section. A debt instrument does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See § 1.1275-4 for the treatment of a debt instrument that provides for a contingency that is not described in this paragraph (c). See § 1.1273-1(c) to determine whether stated interest on a debt instrument subject to this paragraph (c) is qualified stated interest.

(2) *Payment schedule that is significantly more likely than not to occur.* If, based on all the facts and circumstances as of the issue date, a single payment schedule for a debt instrument, including the stated payment schedule, is significantly more likely than not to occur, the yield and maturity of the debt instrument are computed based on this payment schedule.

(3) *Mandatory sinking fund provision.* Notwithstanding paragraph (c)(2) of this section, if a debt instrument is subject to a mandatory sinking fund provision, the provision is ignored for

purposes of computing the yield and maturity of the debt instrument if the use and terms of the provision meet reasonable commercial standards. For purposes of the preceding sentence, a mandatory sinking fund provision is a provision that meets the following requirements:

(i) The provision requires the issuer to redeem a certain amount of debt instruments in an issue prior to maturity.

(ii) The debt instruments actually redeemed are chosen by lot or purchased by the issuer either in the open market or pursuant to an offer made to all holders (with any proration determined by lot).

(iii) On the issue date, the specific debt instruments that will be redeemed on any date prior to maturity cannot be identified.

(4) *Consistency rule.* [Reserved]

(5) *Treatment of certain options.* Notwithstanding paragraphs (c) (2) and (3) of this section, the rules of this paragraph (c)(5) determine the yield and maturity of a debt instrument that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the term of the debt instrument, that, if exercised, require payments to be made on the debt instrument under an alternative payment schedule or schedules (e.g., an option to extend or an option to call a debt instrument at a fixed premium). Under this paragraph (c)(5), an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument, and a holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument. If both the issuer and the holder have options, the rules of this paragraph (c)(5) are applied to the options in the order that they may be exercised. See paragraph (j) *Example 5* through *Example 8* of this section.

(6) *Subsequent adjustments.* If a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(5) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to this paragraph (c) (a

change in circumstances), then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to its adjusted issue price on that date. See paragraph (j) *Example 5* and *Example 7* of this section. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in § 1.1275-2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the debt instrument, which may result in gain or loss to the holder. See paragraph (j) *Example 6* and *Example 8* of this section.

(7) *Effective date.* This paragraph (c) applies to debt instruments issued on or after August 13, 1996.

(d) *Certain debt instruments that provide for a fixed yield.* If a debt instrument provides for one or more contingent payments but all possible payment schedules under the terms of the instrument result in the same fixed yield, the yield of the debt instrument is the fixed yield. For example, the yield of a debt instrument with principal payments that are fixed in total amount but that are uncertain as to time (such as a demand loan) is the stated interest rate if the issue price of the instrument is equal to the stated principal amount and interest is paid or compounded at a fixed rate over the entire term of the instrument. This paragraph (d) applies to debt instruments issued on or after August 13, 1996.

(e) *Convertible debt instruments.* For purposes of section 1272, an option is ignored if it is an option to convert a 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.

(f) *Special rules to determine whether a debt instrument is a short-term obligation—(1) Counting of either the issue date or maturity date.* For purposes of determining whether a debt instrument is a short-term obligation (i.e., a debt instrument with a fixed maturity date that is not more than 1 year from the date of issue), the term of the debt in-

strument includes either the issue date or the maturity date, but not both dates.

(2) *Coordination with paragraph (c) of this section for certain sections of the Internal Revenue Code.* Notwithstanding paragraph (c) of this section, solely for purposes of determining whether a debt instrument is a short-term obligation under sections 871(g)(1)(B)(i), 881, 1271(a)(3), 1271(a)(4), 1272(a)(2)(C), and 1283(a)(1), the maturity date of a debt instrument is the last possible date that the instrument could be outstanding under the terms of the instrument. For purposes of the preceding sentence, the last possible date that the debt instrument could be outstanding is determined without regard to § 1.1275-2(h) (relating to payments subject to remote or incidental contingencies).

(g) *Basis adjustment.* The basis of a debt instrument in the hands of the holder is increased by the amount of OID included in the holder's gross income and decreased by the amount of any payment from the issuer to the holder under the debt instrument other than a payment of qualified stated interest. See, however, § 1.1275-2(f) for rules regarding basis adjustments on a pro rata prepayment.

(h) *Debt instruments denominated in a currency other than the U.S. dollar.* Section 1272 and this section apply to a debt instrument that provides for all payments denominated in, or determined by reference to, the functional currency of the taxpayer or qualified business unit of the taxpayer (even if that currency is other than the U.S. dollar). See § 1.988-2(b) to determine interest income or expense for debt instruments that provide for payments denominated in, or determined by reference to, a nonfunctional currency.

(i) [Reserved]

(j) *Examples.* The following examples illustrate the rules of this section. Each example assumes that all taxpayers use the calendar year as the taxable year. In addition, each example assumes a 30-day month, 360-day year, and that the initial accrual period begins on the issue date and the final accrual period ends on the day before the stated maturity date. Although, for purposes of simplicity, the yield as

stated is rounded to two decimal places, the computations do not reflect any such rounding convention.

Example 1. Accrual of OID on zero coupon debt instrument; choice of accrual periods—(i) *Facts.* On July 1, 1994, A purchases at original issue, for \$675,564.17, a debt instrument that matures on July 1, 1999, and provides for a single payment of \$1,000,000 at maturity.

(ii) *Determination of yield.* Under paragraph (b)(1)(i) of this section, the yield of the debt instrument is 8 percent, compounded semiannually.

(iii) *Determination of accrual period.* Under paragraph (b)(1)(ii) of this section, accrual periods may be of any length, provided that each accrual period is no longer than 1 year and each scheduled payment of principal or interest occurs either on the first or final day of an accrual period. The yield to maturity to be used in computing OID accruals in any accrual period, however, must reflect the length of the accrual period chosen. A yield based on compounding b times per year is equivalent to a yield based on compounding c times per year as indicated by the following formula:

$$r=c\{(1+i/b)^{b/c}-1\}$$

In which:

i=The yield based on compounding b times per year expressed as a decimal

r=The equivalent yield based on compounding c times per year expressed as a decimal

b=The number of compounding periods in a year on which i is based (for example, 12, if i is based on monthly compounding)

c=The number of compounding periods in a year on which r is based

(iv) *Determination of OID allocable to each accrual period.* Assume that A decides to compute OID on the debt instrument using semiannual accrual periods. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first semiannual accrual period is \$27,022.56: the product of the issue price (\$675,564.17) and the yield properly adjusted for the length of the accrual period (8 percent/2), less qualified stated interest allocable to the accrual period (\$0). The daily portion of OID for the first semiannual accrual period is \$150.13 (\$27,022.56/180).

(v) *Determination of OID if monthly accrual periods are used.* Alternatively, assume that A decides to compute OID on the debt instrument using monthly accrual periods. Using the above formula, the yield on the debt instrument reflecting monthly compounding is 7.87 percent, compounded monthly ($12\{(1+.08/2)^{2/12}-1\}$). Under paragraph (b)(1)(iii) of this section, the OID allocable to the first monthly accrual period is \$4,430.48: the product of the issue price (\$675,564.17) and the yield

properly adjusted for the length of the accrual period (7.87 percent/12), less qualified stated interest allocable to the accrual period (\$0). The daily portion of OID for the first monthly accrual period is \$147.68 (\$4,430.48/30).

Example 2. Accrual of OID on debt instrument with qualified stated interest—(i) *Facts.* On September 1, 1994, A purchases at original issue, for \$90,000, B corporation's debt instrument that matures on September 1, 2004, and has a stated principal amount of \$100,000, payable on that date. The debt instrument provides for semiannual payments of interest of \$3,000, payable on September 1 and March 1 of each year, beginning on March 1, 1995.

(ii) *Determination of yield.* The debt instrument is a 10-year debt instrument with an issue price of \$90,000 and a stated redemption price at maturity of \$100,000. The semiannual payments of \$3,000 are qualified stated interest payments. Under paragraph (b)(1)(i) of this section, the yield is 7.44 percent, compounded semiannually.

(iii) *Accrual of OID if semiannual accrual periods are used.* Assume that A decides to compute OID on the debt instrument using semiannual accrual periods. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first semiannual accrual period equals the product of the issue price (\$90,000) and the yield properly adjusted for the length of the accrual period (7.44 percent/2), less qualified stated interest allocable to the accrual period (\$3,000). Therefore, the amount of OID for the first semiannual accrual period is \$345.78 (\$3,345.78-\$3,000).

(iv) *Adjustment for accrued but unpaid qualified stated interest if monthly accrual periods are used.* Assume, alternatively, that A decides to compute OID on the debt instrument using monthly accrual periods. The yield, compounded monthly, is 7.32 percent. Under paragraph (b)(1)(iii) of this section, the OID allocable to the first monthly accrual period is the product of the issue price (\$90,000) and the yield properly adjusted for the length of the accrual period (7.32 percent/12), less qualified stated interest allocable to the accrual period. Under paragraph (b)(4)(i)(A) of this section, the qualified stated interest allocable to the first monthly accrual period is the pro rata amount of qualified stated interest allocable to the interval between payment dates ($\$3,000 \times \frac{1}{6}$, or \$500). Therefore, the amount of OID for the first monthly accrual period is \$49.18 (\$549.18-\$500). Under paragraph (b)(4)(i)(B) of this section, the adjusted issue price of the debt instrument for purposes of determining the amount of OID for the second monthly accrual period is \$90,549.18 (\$90,000 + \$49.18 + \$500). Although the adjusted issue price of the debt instrument for this purpose includes the amount of qualified stated interest allocable to the first monthly accrual period, A includes the qualified stated interest in income based on

A's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

Example 3. Accrual of OID for debt instrument with initial short accrual period—(i) Facts. On May 1, 1994, G purchases at original issue, for \$80,000, H corporation's debt instrument maturing on July 1, 2004. The debt instrument provides for a single payment at maturity of \$250,000. G computes its OID using 6-month accrual periods ending on January 1 and July 1 of each year and an initial short 2-month accrual period from May 1, 1994, through June 30, 1994.

(ii) *Determination of yield.* The yield on the debt instrument is 11.53 percent, compounded semiannually.

(iii) *Determination of OID allocable to initial short accrual period.* Under paragraph (b)(4)(iii) of this section, G may use any reasonable method to compute OID for the initial short accrual period. One reasonable method is to calculate the amount of OID pursuant to the following formula:

$$OID_{short} = IP \times (i/k) \times f$$

In which:

OID_{short} = The amount of OID allocable to the initial short accrual period

IP = The issue price of the debt instrument

i = The yield to maturity expressed as a decimal

k = The number of accrual periods in a year

f = A fraction whose numerator is the number of days in the initial short accrual period, and whose denominator is the number of days in a full accrual period

(iv) *Amount of OID for the initial short accrual period.* Under this method, the amount of OID for the initial short accrual period is \$1,537 ($\$80,000 \times (11.53 \text{ percent}/2) \times (60/180)$).

(v) *Alternative method.* Another reasonable method is to calculate the amount of OID for the initial short accrual period using the yield based on bi-monthly compounding, computed pursuant to the formula set forth in *Example 1* of paragraph (j) of this section. Under this method, the amount of OID for the initial short accrual period is \$1,508.38 ($\$80,000 \times (11.31 \text{ percent}/6)$).

Example 4. Impermissible accrual of OID using a method other than constant yield method—(i) Facts. On July 1, 1994, B purchases at original issue, for \$100,000, C corporation's debt instrument that matures on July 1, 1999, and has a stated principal amount of \$100,000. The debt instrument provides for a single payment at maturity of \$148,024.43. The yield of the debt instrument is 8 percent, compounded semiannually.

(ii) *Determination of yield.* Assume that C uses 6 monthly accrual periods to compute its OID for 1994. The yield must reflect monthly compounding (as determined using the formula described in *Example 1* of paragraph (j) of this section). As a result, the

monthly yield of the debt instrument is 7.87 percent, divided by 12. C may not compute its monthly yield for the last 6 months in 1994 by dividing 8 percent by 12.

Example 5. Debt instrument subject to put option—(i) Facts. On January 1, 1995, G purchases at original issue, for \$70,000, H corporation's debt instrument maturing on January 1, 2010, with a stated principal amount of \$100,000, payable at maturity. The debt instrument provides for semiannual payments of interest of \$4,000, payable on January 1 and July 1 of each year, beginning on July 1, 1995. The debt instrument gives G an unconditional right to put the bond back to H, exercisable on January 1, 2005, in return for \$85,000 (exclusive of the \$4,000 of stated interest payable on that date).

(ii) *Determination of yield and maturity.* Yield determined without regard to the put option is 12.47 percent, compounded semiannually. Yield determined by assuming that the put option is exercised (i.e., by using January 1, 2005, as the maturity date and \$85,000 as the stated principal amount payable on that date) is 12.56 percent, compounded semiannually. Thus, under paragraph (c)(5) of this section, it is assumed that G will exercise the put option, because exercise of the option would increase the yield of the debt instrument. Thus, for purposes of calculating OID, the debt instrument is assumed to be a 10-year debt instrument with an issue price of \$70,000, a stated redemption price at maturity of \$85,000, and a yield of 12.56 percent, compounded semiannually.

(iii) *Consequences if put option is, in fact, not exercised.* If the put option is, in fact, not exercised, then, under paragraph (c)(6) of this section, the debt instrument is treated, solely for purposes of sections 1272 and 1273, as if it were reissued on January 1, 2005, for an amount equal to its adjusted issue price on that date, \$85,000. The new debt instrument matures on January 1, 2010, with a stated principal amount of \$100,000 payable on that date and provides for semiannual payments of interest of \$4,000. The yield of the new debt instrument is 12.08 percent, compounded semiannually.

Example 6. Debt instrument subject to partial call option—(i) Facts. On January 1, 1995, H purchases at original issue, for \$95,000, J corporation's debt instrument that matures on January 1, 2000, and has a stated principal amount of \$100,000, payable on that date. The debt instrument provides for semiannual payments of interest of \$4,000, payable on January 1 and July 1 of each year, beginning on July 1, 1995. On January 1, 1998, J has an unconditional right to call 50 percent of the principal amount of the debt instrument for \$55,000 (exclusive of the \$4,000 of stated interest payable on that date). If the call is exercised, the semiannual payments of interest

made after the call date will be reduced to \$2,000.

(ii) *Determination of yield and maturity.* Yield determined without regard to the call option is 9.27 percent, compounded semiannually. Yield determined by assuming J exercises its call option is 10.75 percent, compounded semiannually. Thus, under paragraph (c)(5) of this section, it is assumed that J will not exercise the call option because exercise of the option would increase the yield of the debt instrument. Thus, for purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of \$100,000, and a yield of 9.27 percent, compounded semiannually.

(iii) *Consequences if the call option is, in fact, exercised.* If the call option is, in fact, exercised, then under paragraph (c)(6) of this section, the debt instrument is treated as if the issuer made a pro rata prepayment of \$55,000 that is subject to § 1.1275-2(f). Consequently, under § 1.1275-2(f)(1), the instrument is treated as consisting of two debt instruments, one that is retired on the call date and one that remains outstanding after the call date. The adjusted issue price, adjusted basis in the hands of the holder, and accrued OID of the original debt instrument is allocated between the two instruments based on the portion of the original instrument treated as retired. Since each payment remaining to be made after the call date is reduced by one-half, one-half of the adjusted issue price, adjusted basis, and accrued OID is allocated to the debt instrument that is treated as retired. The adjusted issue price of the original debt instrument immediately prior to the call date is \$97,725.12, which equals the issue price of the original debt instrument (\$95,000) increased by the OID previously includible in gross income (\$2,725.12). One-half of this adjusted issue price is allocated to the debt instrument treated as retired, and the other half is allocated to the debt instrument that is treated as remaining outstanding. Thus, the debt instrument treated as remaining outstanding has an adjusted issue price immediately after the call date of \$97,725.12/2, or \$48,862.56. The yield of this debt instrument continues to be 9.27 percent, compounded semiannually. In addition, the portion of H's adjusted basis allocated to the debt instrument treated as retired is \$97,725.12/2 or \$48,862.56. Accordingly, under section 1271, H realizes a gain on the deemed retirement equal to \$6,137.44 (\$55,000 - \$48,862.56).

Example 7. Debt instrument issued at par that provides for payment of interest in kind—(i) Facts. On January 1, 1995, A purchases at original issue, for \$100,000, X corporation's debt instrument maturing on January 1, 2000, at a stated principal amount of \$100,000, payable on that date. The debt instrument provides for annual payments of interest of

\$6,000 on January 1 of each year, beginning on January 1, 1996. The debt instrument gives X the unconditional right to issue, in lieu of the first interest payment, a second debt instrument (PIK instrument) maturing on January 1, 2000, with a stated principal amount of \$6,000. The PIK instrument, if issued, would provide for annual payments of interest of \$360 on January 1 of each year, beginning on January 1, 1997.

(ii) *Aggregation of PIK instrument with original debt instrument.* Under § 1.1275-2(c)(3), the issuance of the PIK instrument is not considered a payment made on the original debt instrument, and the PIK instrument is aggregated with the original debt instrument. The issue date of the PIK instrument is the same as the original debt instrument.

(iii) *Determination of yield and maturity.* The right to issue the PIK instrument is treated as an option to defer the initial interest payment until maturity. Yield determined without regard to the option is 6 percent, compounded annually. Yield determined by assuming X exercises the option is 6 percent, compounded annually. Thus, under paragraph (c)(5) of this section, it is assumed that X will not exercise the option by issuing the PIK instrument because exercise of the option would not decrease the yield of the debt instrument. For purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of \$100,000 and ten semiannual interest payments of \$6,000, beginning on January 1, 1996. As a result, the debt instrument's yield is 6 percent, compounded annually.

(iv) *Determination of OID.* Under the payment schedule that would result if the option was exercised, none of the interest on the debt instrument would be qualified stated interest. Accordingly, under § 1.1273-1(c)(2), no payments on the debt instrument are qualified stated interest payments. Thus, \$6,000 of OID accrues during the first annual accrual period. If the PIK instrument is not issued, \$6,000 of OID accrues during each annual accrual period.

(v) *Consequences if the PIK instrument is issued.* Under paragraph (c)(6) of this section, if X issues the PIK instrument on January 1, 1996, the issuance of the PIK instrument is not a payment on the debt instrument. Solely for purposes of sections 1272 and 1273, the debt instrument is deemed reissued on January 1, 1996, for an issue price of \$106,000. The recomputed yield is 6 percent, compounded annually. The OID for the first annual accrual period after the deemed reissuance is \$6,360. The adjusted issue price of the debt instrument at the beginning of the next annual accrual period is \$106,000 (\$106,000 + \$6,360 - \$6,360). The OID for each of the four remaining annual accrual periods is \$6,360.

Example 8. Debt instrument issued at a discount that provides for payment of interest in

kind—(i) *Facts.* On January 1, 1995, T purchases at original issue, for \$75,500, U corporation's debt instrument maturing on January 1, 2000, at a stated principal amount of \$100,000, payable on that date. The debt instrument provides for annual payments of interest of \$4,000 on January 1 of each year, beginning on January 1, 1996. The debt instrument gives U the unconditional right to issue, in lieu of the first interest payment, a second debt instrument (PIK instrument) maturing on January 1, 2000, with a stated principal amount of \$4,000. The PIK instrument, if issued, would provide for annual payments of interest of \$160 on January 1 of each year, beginning on January 1, 1997.

(ii) *Aggregation of PIK instrument with original debt instrument.* Under § 1.1275-2(c)(3), the issuance of the PIK instrument is not considered a payment made on the original debt instrument, and the PIK instrument is aggregated with the original debt instrument. The issue date of the PIK instrument is the same as the original debt instrument.

(iii) *Determination of yield and maturity.* The right to issue the PIK instrument is treated as an option to defer the initial interest payment until maturity. Yield determined without regard to the option is 10.55 percent, compounded annually. Yield determined by assuming U exercises the option is 10.32 percent, compounded annually. Thus, under paragraph (c)(5) of this section, it is assumed that U will exercise the option by issuing the PIK instrument because exercise of the option would decrease the yield of the debt instrument. For purposes of calculating OID, the debt instrument is assumed to be a 5-year debt instrument with a single principal payment at maturity of \$104,000 and four annual interest payments of \$4,160, beginning on January 1, 1997. As a result, the yield is 10.32 percent, compounded annually.

(iv) *Consequences if the PIK instrument is not issued.* Assume that T chooses to compute OID accruals on the basis of an annual accrual period. On January 1, 1996, the adjusted issue price of the debt instrument, and T's adjusted basis in the instrument, is \$83,295.15. Under paragraph (c)(6) of this section, if U actually makes the \$4,000 interest payment on January 1, 1996, the debt instrument is treated as if U made a pro rata prepayment (within the meaning of § 1.1275-2(f)(2)) of \$4,000, which reduces the amount of each payment remaining on the instrument by a factor of $4/104$, or $1/26$. Thus, under § 1.1275-2(f)(1) and section 1271, T realizes a gain of \$796.34 ($\$4,000 - (\$83,295.15/26)$). The adjusted issue price of the debt instrument and T's adjusted basis immediately after the payment is \$80,091.49 ($\$83,295.15 \times 25/26$) and the yield continues to be 10.32 percent, compounded annually.

Example 9. Debt instrument with stepped interest rate—(i) *Facts.* On July 1, 1994, G purchases at original issue, for \$85,000, H cor-

poration's debt instrument maturing on July 1, 2004. The debt instrument has a stated principal amount of \$100,000, payable on the maturity date and provides for semiannual interest payments on January 1 and July 1 of each year, beginning on January 1, 1995. The amount of each payment is \$2,000 for the first 5 years and \$5,000 for the final 5 years.

(ii) *Determination of OID.* Assume that G computes its OID using 6-month accrual periods ending on January 1 and July 1 of each year. The yield of the debt instrument, determined under paragraph (b)(1)(i) of this section, is 8.65 percent, compounded semiannually. Interest is unconditionally payable at a fixed rate of at least 4 percent, compounded semiannually, for the entire term of the debt instrument. Consequently, under § 1.1273-1(c)(1), the semiannual payments are qualified stated interest payments to the extent of \$2,000. The amount of OID for the first 6-month accrual period is \$1,674.34 (the issue price of the debt instrument (\$85,000) times the yield of the debt instrument for that accrual period (.0865/2) less the amount of any qualified stated interest allocable to that accrual period (\$2,000)).

Example 10. Debt instrument payable on demand that provides for interest at a constant rate—(i) *Facts.* On January 1, 1995, V purchases at original issue, for \$100,000, W corporation's debt instrument. The debt instrument calls for interest to accrue at a rate of 9 percent, compounded annually. The debt instrument is redeemable at any time at the option of V for an amount equal to \$100,000, plus accrued interest. V uses annual accrual periods to accrue OID on the debt instrument.

(ii) *Amount of OID.* Pursuant to paragraph (d) of this section, the yield of the debt instrument is 9 percent, compounded annually. If the debt instrument is not redeemed during 1995, the amount of OID allocable to the year is \$9,000.

[T.D. 8517, 59 FR 4810, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30140, June 14, 1996]

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

(a) *In general.* Under section 1272(c)(1), if a holder purchases a debt instrument at a premium, the holder does not include any OID in gross income. Under section 1272(a)(7), if a holder purchases a debt instrument at an acquisition premium, the holder reduces the amount of OID includible in gross income by the fraction determined under paragraph (b)(4) of this section.

(b) *Definitions and special rules*—(1) *Purchase.* For purposes of section 1272 and this section, purchase means any