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 × 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 corporation'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 acquisition of a debt instrument, including the acquisition of a newly issued debt instrument in a debt-for-debt exchange or the acquisition of a debt instrument from a donor.

(2) *Premium*. A debt instrument is purchased at a premium if its adjusted basis, immediately after its purchase by the holder (including a purchase at original issue), exceeds the sum of all amounts payable on the instrument after the purchase date other than payments of qualified stated interest (as defined in § 1.1273–1(c)).

(3) *Acquisition premium*. A debt instrument is purchased at an acquisition premium if its adjusted basis, immediately after its purchase (including a purchase at original issue), is—

(i) Less than or equal to the sum of all amounts payable on the instrument after the purchase date other than payments of qualified stated interest (as defined in § 1.1273–1(c)); and

(ii) Greater than the instrument's adjusted issue price (as defined in § 1.1275–1(b)).

(4) *Acquisition premium fraction*. In applying section 1272(a)(7), the cost of a debt instrument is its adjusted basis immediately after its acquisition by the purchaser. Thus, the numerator of the fraction determined under section 1272(a)(7)(B) is the excess of the adjusted basis of the debt instrument immediately after its acquisition by the purchaser over the adjusted issue price of the debt instrument. The denominator of the fraction determined under section 1272(a)(7)(B) is the excess of the sum of all amounts payable on the debt instrument after the purchase date, other than payments of qualified stated interest, over the instrument's adjusted issue price.

(5) *Election to accrue discount on a constant yield basis*. Rather than applying the acquisition premium fraction, a holder of a debt instrument purchased at an acquisition premium may elect under § 1.1272–3 to compute OID accruals by treating the purchase as a purchase at original issuance and applying the mechanics of the constant yield method.

(6) *Special rules for determining basis*—(i) *Debt instruments acquired in exchange for other property*. For purposes of section 1272(a)(7), section 1272(c)(1), and this section, if a debt instrument is acquired in an exchange for other property (other than in a reorganization defined in section 368) and the basis of the debt instrument is determined, in whole or in part, by reference to the basis of the other property, the basis of the debt instrument may not exceed its fair market value immediately after the exchange. For example, if a debt instrument is distributed by a partnership to a partner in a liquidating distribution and the partner's basis in the debt instrument would otherwise be determined under section 732, the partner's basis in the debt instrument may not exceed its fair market value for purposes of this section.

(ii) *Acquisition by gift*. For purposes of this section, a donee's adjusted basis in a debt instrument is the donee's basis for determining gain under section 1015(a).

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

Example 1. Debt instrument purchased at an acquisition premium—(i) *Facts*. On July 1, 1994, A purchased at original issue, for $500, a debt instrument issued by Corporation X. The debt instrument matures on July 1, 1999, and calls for a single payment at maturity of $1,000. Under section 1273(a), the debt instrument has a stated redemption price at maturity of $1,000 and, thus, OID of $500. On July 1, 1996, when the debt instrument's adjusted issue price is $659.75, A sells the debt instrument to B for $750 in cash.

(ii) *Acquisition premium fraction*. Because the cost to B of the debt instrument is less than the amount payable on the debt instrument after the purchase date, but is greater than the debt instrument's adjusted issue price, B has paid an acquisition premium for the debt instrument. Accordingly, the daily portion of OID for any day that B holds the debt instrument is reduced by a fraction, the numerator of which is $90.25 (the excess of the cost of the debt instrument over its adjusted issue price) and the denominator of which is $340.25 (the excess of the sum of all payments after the purchase date over its adjusted issue price).

Example 2. *Debt-for-debt exchange where holder is considered to purchase new debt instrument at a premium*—(i) *Facts*. On January 1, 1995, H purchases at original issue, for $1,000, a debt instrument issued by Corporation X. On July 1, 1997, when H's adjusted basis in the debt instrument is $1,000, Corporation X issues a new debt instrument with a stated redemption price at maturity of $750 to H in exchange for the old debt instrument. Assume that the issue price of the new debt instrument is $600. Thus, under section 1273(a), the debt instrument has OID of $150. The exchange qualifies as a recapitalization under section 368(a)(1)(E), with the consequence that, under sections 354 and 358, H recognizes no loss on the exchange and has an adjusted basis in the new debt instrument of $1,000.

(ii) *Application of section 1272(c)(1).* Under paragraphs (b)(1) and (b)(2) of this section, H purchases the new debt instrument at a premium of $250. Accordingly, under section 1272(c)(1), H is not required to include OID in income with respect to the new debt instrument.

Example 3. Debt-for-debt exchange where holder is considered to purchase new debt instrument at an acquisition premium—(i) *Facts.* The facts are the same as in *Example 2* of paragraph (c) of this section, except that H purchases the old debt instrument from another holder on July 1, 1995, and on July 1, 1997, H's adjusted basis in the old debt instrument is $700. Under section 1273(a), the new debt instrument is issued with OID of $150.

(ii) *Application of section 1272(a)(7).* Under paragraphs (b)(1) and (b)(3) of this section, H purchases the new debt instrument at an acquisition premium of $100. Accordingly, the daily portion of OID that is includible in H's income is reduced by the fraction determined under section 1272(a)(7).

Example 4. Treatment of acquisition premium for debt instrument acquired by gift—(i) *Facts.* On July 1, 1994, D receives as a gift a debt instrument with a stated redemption price at maturity of $1,000 and an adjusted issue price of $800. On that date, the fair market value of the debt instrument is $900 and the donor's adjusted basis in the debt instrument is $950.

(ii) *Application of section 1272(a)(7).* Under paragraphs (b)(1), (b)(3), and (b)(6)(ii) of this section, D is considered to have purchased the debt instrument at an acquisition premium of $150. Accordingly, the daily portion of OID that is includible in D's income is reduced by the fraction determined under section 1272(a)(7).

[T.D. 8517, 59 FR 4814, Feb. 2, 1994]

§ 1.1272–3 Election by a holder to treat all interest on a debt instrument as OID.

(a) *Election.* A holder of a debt instrument may elect to include in gross income all interest that accrues on the instrument by using the constant yield method described in paragraph (c) of this section. For purposes of this election, interest includes stated interest, acquisition discount, OID, de minimis OID, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium.

(b) *Scope of election*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, a holder may make the election for any debt instrument.

(2) *Exceptions, limitations, and special rules*—(i) *Debt instrument with amortizable bond premium (as determined under section 171).* (A) A holder may make the election for a debt instrument with amortizable bond premium only if the instrument qualifies as a bond under section 171(d).

(B) If a holder makes the election under this section for a debt instrument with amortizable bond premium, the holder is deemed to have made the election under section 171(c)(2) for the taxable year in which the instrument was acquired. If the holder has previously made the election under section 171(c)(2), the requirements of that election with respect to any debt instrument are satisfied by electing to amortize the bond premium under the rules provided by this section.

(ii) *Debt instrument with market discount.* (A) A holder may make the election under this section for a debt instrument with market discount only if the holder is eligible to make an election under section 1278(b).

(B) If a holder makes the election under this section for a debt instrument with market discount, the holder is deemed to have made both the election under section 1276(b)(2) for that instrument and the election under section 1278(b) for the taxable year in which the instrument was acquired. If the holder has previously made the election under section 1278(b), the requirements of that election with respect to any debt instrument are satisfied by electing to include the market discount in income in accordance with the rules provided by this section.

(iii) *Tax-exempt debt instrument.* A holder may not make the election for a tax-exempt obligation as defined in section 1275(a)(3).

(c) *Mechanics of the constant yield method*—(1) *In general.* For purposes of this section, the amount of interest that accrues during an accrual period is determined under rules similar to those under section 1272 (the constant