

**§ 1.171-3 Special rules for certain bonds.**

(a) *Variable rate debt instruments.* A holder determines bond premium on a variable rate debt instrument by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument. The holder also allocates any bond premium among the accrual periods by reference to the equivalent fixed rate debt instrument. The holder constructs the equivalent fixed rate debt instrument, as of the date the holder acquires the variable rate debt instrument, by using the principles of § 1.1275-5(e). See paragraph (e) *Example 1* of this section.

(b) *Inflation-indexed debt instruments.* A holder determines bond premium on an inflation-indexed debt instrument by assuming that there will be no inflation or deflation over the remaining term of the instrument. The holder also allocates any bond premium among the accrual periods by assuming that there will be no inflation or deflation over the remaining term of the instrument. The bond premium allocable to an accrual period offsets qualified stated interest allocable to the period. Notwithstanding § 1.171-2(a)(4), if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment under § 1.1275-7(f)(1)(i). However, the rules in § 1.171-2(a)(4)(i)(C) apply to any remaining deflation adjustment attributable to bond premium as of the end of the holder's accrual period in which the bond is sold, retired, or otherwise disposed of. See § 1.1275-7 for other rules relating to inflation-indexed debt instruments.

(c) *Yield and remaining payment schedule of certain bonds subject to contingencies—(1) Applicability.* This paragraph (c) provides rules that apply in determining the yield and remaining payment schedule of certain bonds 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 date the holder acquires the bond (the acquisition date) and the bond is subject to paragraph (c)(2), (3), or (4) of this section. A bond 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 bond that provides for a contingency that is not described in this paragraph (c).

(2) *Remaining payment schedule that is significantly more likely than not to occur.* If, based on all the facts and circumstances as of the acquisition date, a single remaining payment schedule for a bond is significantly more likely than not to occur, this remaining payment schedule is used to determine and amortize bond premium under §§ 1.171-1 and 1.171-2.

(3) *Mandatory sinking fund provision.* Notwithstanding paragraph (c)(2) of this section, if a bond is subject to a mandatory sinking fund provision described in § 1.1272-1(c)(3), the provision is ignored for purposes of determining and amortizing bond premium under §§ 1.171-1 and 1.171-2.

(4) *Treatment of certain options—(i) Applicability.* Notwithstanding paragraphs (c)(2) and (3) of this section, the rules of this paragraph (c)(4) determine the remaining payment schedule of a bond that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the remaining term of the bond, to alter the bond's remaining payment schedule.

(ii) *Operating rules.* A holder determines the remaining payment schedule of a bond by assuming that each option will (or will not) be exercised under the following rules:

(A) *Issuer options.* In general, the issuer is deemed to exercise or not exercise an option or combination of options in the manner that minimizes the holder's yield on the obligation. However, the issuer of a taxable bond is deemed to exercise or not exercise a call option or combination of call options in the manner that maximizes the holder's yield on the bond.

(B) *Holder options.* A holder is deemed to exercise or not exercise an option or combination of options in the manner

that maximizes the holder's yield on the bond.

(C) *Multiple options.* If both the issuer and the holder have options, the rules of paragraphs (c)(4)(ii)(A) and (B) of this section are applied to the options in the order that they may be exercised. Thus, the deemed exercise of one option may eliminate other options that are later in time.

(5) *Subsequent adjustments—(i) In general.* Except as provided in paragraph (c)(5)(ii) of this section, if a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(4) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to paragraph (c) of this section (a change in circumstances), then solely for purposes of section 171, the bond is treated as retired and reacquired by the holder on the date of the change in circumstances for an amount equal to the adjusted acquisition price of the bond as of that date. 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 bond. See paragraph (e) *Example 2* of this section.

(ii) *Bond premium deduction on the issuer's call of a taxable bond.* If a change in circumstances results from an issuer's call of a taxable bond or a partial call that is a pro-rata prepayment, the holder may deduct as bond premium an amount equal to the excess, if any, of the holder's adjusted acquisition price of the bond over the greater of—

(A) The amount received on redemption; and

(B) The amounts that would have been payable under the bond (other than payments of qualified stated interest) if no change in circumstances had occurred.

(d) *Remote and incidental contingencies.* For purposes of determining and amortizing bond premium, if a bond provides for a contingency that is remote or incidental (within the meaning of § 1.1275-2(h)), the holder takes the contingency into account under the rules for remote and incidental contingencies in § 1.1275-2(h).

(e) *Examples.* The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention. The examples are as follows:

*Example 1. Variable rate debt instrument.* (i) *Facts.* On March 1, 1999, E purchases for \$110,000 a taxable bond maturing on March 1, 2007, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest on March 1 of each year based on the percentage appreciation of a nationally-known commodity index. On March 1, 1999, it is reasonably expected that the bond will yield 12 percent, compounded annually. E uses the cash receipts and disbursements method of accounting, and E decides to use annual accrual periods ending on March 1 of each year. Assume that the bond is a variable rate debt instrument under § 1.1275-5.

(ii) *Amount of bond premium.* Because the bond is a variable rate debt instrument, E determines and amortizes its bond premium by reference to the equivalent fixed rate debt instrument constructed for the bond as of March 1, 1999. Because the bond provides for interest at a single objective rate that is reasonably expected to yield 12 percent, compounded annually, the equivalent fixed rate debt instrument for the bond is an eight-year bond with a principal amount of \$100,000, payable at maturity. It provides for annual payments of interest of \$12,000. E's basis in the equivalent fixed rate debt instrument is \$110,000. The sum of all amounts payable on the equivalent fixed rate debt instrument (other than payments of qualified stated interest) is \$100,000. Under § 1.171-1, the amount of bond premium is \$10,000 (\$110,000 - \$100,000).

(iii) *Bond premium allocable to each accrual period.* E allocates bond premium to the remaining accrual periods by reference to the payment schedule on the equivalent fixed rate debt instrument. Based on the payment schedule of the equivalent fixed rate debt instrument and E's basis in the bond, E's yield is 10.12 percent, compounded annually. The bond premium allocable to the accrual period ending on March 1, 2000, is the excess of the qualified stated interest allocable to the period for the equivalent fixed rate debt instrument (\$12,000) over the product of the adjusted acquisition price at the beginning of

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the period (\$110,000) and E's yield (10.12 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is \$870.71 (\$12,000 - \$11,129.29). The bond premium allocable to all the accrual periods is listed in the following schedule:

Accrual period ending	Adjusted acquisition price at beginning of accrual period	Premium allocable to accrual period
3/1/00 .....	\$110,000.00	\$870.71
3/1/01 .....	109,129.29	958.81
3/1/02 .....	108,170.48	1,055.82
3/1/03 .....	107,114.66	1,162.64
3/1/04 .....	105,952.02	1,280.27
3/1/05 .....	104,671.75	1,409.80
3/1/06 .....	103,261.95	1,552.44
3/1/07 .....	101,709.51	1,709.51
		10,000.00

(iv) *Qualified stated interest for each accrual period.* Assume the bond actually pays the following amounts of qualified stated interest:

Accrual period ending	Qualified stated interest
3/1/00 .....	\$2,000.00
3/1/01 .....	0.00
3/1/02 .....	0.00
3/1/03 .....	10,000.00
3/1/04 .....	8,000.00
3/1/05 .....	12,000.00
3/1/06 .....	15,000.00
3/1/07 .....	8,500.00

(v) *Premium used to offset interest.* E's interest income for each accrual period is deter-

mined by offsetting the qualified stated interest allocable to the period with the bond premium allocable to the period. For the accrual period ending on March 1, 2000, E includes in income \$1,129.29, the qualified stated interest allocable to the period (\$2,000) offset with the bond premium allocable to the period (\$870.71). For the accrual period ending on March 1, 2001, the bond premium allocable to the accrual period (\$958.81) exceeds the qualified stated interest allocable to the period (\$0) and, therefore, E does not have interest income for this accrual period. However, under § 1.171-2(a)(4)(i)(A), E may deduct as bond premium \$958.81, the excess of the bond premium allocable to the accrual period (\$958.81) over the qualified stated interest allocable to the accrual period (\$0). For the accrual period ending on March 1, 2002, the bond premium allocable to the accrual period (\$1,055.82) exceeds the qualified stated interest allocable to the accrual period (\$0) and, therefore, E does not have interest income for the accrual period. Under § 1.171-2(a)(4)(i)(A), E's deduction for bond premium for the accrual period is limited to \$170.48, the excess of E's total interest inclusions on the bond in prior accrual periods (\$1,129.29) over the total amount treated by E as a bond premium deduction in prior accrual periods (\$958.81). Under § 1.171-2(a)(4)(i)(B), E must carry forward the remaining \$885.34 of bond premium allocable to the period ending March 1, 2002, and treat it as bond premium allocable to the period ending March 1, 2003. The amount E includes in income for each accrual period is shown in the following schedule:

Accrual period ending	Qualified stated interest	Premium allocable to accrual period	Interest income	Premium deduction	Premium carryforward
3/1/00 .....	\$2,000.00	\$870.71	\$1,129.29	.....	.....
3/1/01 .....	0.00	958.81	0.00	\$958.81	.....
3/1/02 .....	0.00	1,055.82	0.00	170.48	\$885.34
3/1/03 .....	10,000.00	1,162.64	7,951.93	.....	.....
3/1/04 .....	8,000.00	1,280.27	6,719.73	.....	.....
3/1/05 .....	12,000.00	1,409.80	10,590.20	.....	.....
3/1/06 .....	15,000.00	1,552.44	13,447.56	.....	.....
3/1/07 .....	8,500.00	1,709.51	6,790.49	.....	.....
		10,000.00	.....	.....	.....

*Example 2. Partial call that results in a pro-rata prepayment.* (i) *Facts.* On April 1, 1999, M purchases for \$110,000 N's taxable bond maturing on April 1, 2006, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest of \$10,000, payable on April 1 of each year. N has the option to call all or part of the bond on April 1, 2001, at a 5 percent premium over the principal amount. M uses the cash receipts and disbursements method of accounting.

(ii) *Determination of yield and the remaining payment schedule.* M's yield determined without regard to the call option is 8.07 percent, compounded annually. M's yield determined by assuming N exercises its call option is 6.89 percent, compounded annually. Under paragraph (c)(4)(ii)(A) of this section, it is assumed N will not exercise the call option because exercising the option would minimize M's yield. Thus, for purposes of determining and amortizing bond premium, the bond is

assumed to be a seven-year bond with a single principal payment at maturity of \$100,000.

(iii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is \$100,000. Under § 1.171-1, the amount of bond premium is \$10,000 (\$110,000 - \$100,000).

(iv) *Bond premium allocable to the first two accrual periods.* For the accrual period ending on April 1, 2000, M includes in income \$8,881.83, the qualified stated interest allocable to the period (\$10,000) offset with bond premium allocable to the period (\$1,118.17). The adjusted acquisition price on April 1, 2000, is \$108,881.83 (\$110,000 - \$1,118.17). For the accrual period ending on April 1, 2001, M includes in income \$8,791.54, the qualified stated interest allocable to the period (\$10,000) offset with bond premium allocable to the period (\$1,208.46). The adjusted acquisition price on April 1, 2001, is \$107,673.37 (\$108,881.83 - \$1,208.46).

(v) *Partial call.* Assume N calls one-half of M's bond for \$52,500 on April 1, 2001. Because it was assumed the call would not be exercised, the call is a change in circumstances. However, the partial call is also a pro-rata prepayment within the meaning of § 1.1275-2(f)(2). As a result, the call is treated as a retirement of one-half of the bond. Under paragraph (c)(5)(ii) of this section, M may deduct \$1,336.68, the excess of its adjusted acquisition price in the retired portion of the bond (\$107,673.37/2, or \$53,836.68) over the amount received on redemption (\$52,500). M's adjusted basis in the portion of the bond that remains outstanding is \$53,836.68 (\$107,673.37 - \$53,836.68).

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**§ 1.171-4 Election to amortize bond premium on taxable bonds.**

(a) *Time and manner of making the election—(1) In general.* A holder makes the election to amortize bond premium by offsetting interest income with bond premium in the holder's timely filed federal income tax return for the first taxable year to which the holder desires the election to apply. The holder should attach to the return a statement that the holder is making the election under this section.

(2) *Coordination with OID election.* If a holder makes an election under § 1.1272-3 for a bond with bond premium, the holder is deemed to have made the election under this section.

(b) *Scope of election.* The election under this section applies to all taxable bonds held during or after the taxable year for which the election is made.

(c) *Election to amortize made in a subsequent taxable year—(1) In general.* If a holder elects to amortize bond premium and holds a taxable bond acquired before the taxable year for which the election is made, the holder may not amortize amounts that would have been amortized in prior taxable years had an election been in effect for those prior years.

(2) *Example.* The following example illustrates the rule of this paragraph (c):

*Example.* (i) *Facts.* On May 1, 1999, C purchases for \$130,000 a taxable bond maturing on May 1, 2006, with a stated principal amount of \$100,000, payable at maturity. The bond provides for unconditional payments of interest of \$15,000, payable on May 1 of each year. C uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year. C has not previously elected to amortize bond premium, but does so for 2002.

(ii) *Amount to amortize.* C's basis for determining loss on the sale or exchange of the bond is \$130,000. Thus, under § 1.171-1, the amount of bond premium is \$30,000. Under § 1.171-2, if a bond premium election were in effect for the prior taxable years, C would have amortized \$3,257.44 of bond premium on May 1, 2000, and \$3,551.68 of bond premium on May 1, 2001, based on annual accrual periods ending on May 1. Thus, for 2002 and future years to which the election applies, C may amortize only \$23,190.88 (\$30,000 - \$3,257.44 - \$3,551.68).

(d) *Revocation of election.* The election under this section may not be revoked unless approved by the Commissioner. Because a revocation of the election is a change in accounting method, a taxpayer must follow the rules under § 1.446-1(e)(3)(i) to request the Commissioner's consent to revoke the election. A revocation of the election applies to all taxable bonds held during or after the taxable year for which the revocation is effective. The holder may not amortize any remaining bond premium on bonds held at the beginning of the taxable year for which the revocation is effective. Therefore, no adjustment under section 481 is allowed upon the revocation of the election because no