the positive adjustment from 1999 to 2000. Because Y legged into the integrated transaction with a principal purpose to defer the positive adjustment, the Commissioner may treat the debt instrument as sold for its fair market value on the leg-in date or refuse to allow integration.

Example 6. Integration of offsetting debt instruments. (i) *Facts.* On January 1, 1997, Z issues two 10-year debt instruments. The first, Issue 1, has an issue price of $1,000, pays interest annually at 6 percent, and, at maturity, pays $1,000, increased by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and reduced by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. However, the amount paid at maturity may not be less than $500 or more than $1,500. The second, Issue 2, has an issue price of $1,000, pays interest annually at 8 percent, and, at maturity, pays $1,000, reduced by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and increased by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. The amount paid at maturity may not be less than $500 or more than $1,500. On January 1, 1997, Z identifies Issue 1 as the qualifying debt instrument, Issue 2 as a §1.1275–6 hedge, and otherwise meets the identification requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* Both Issue 1 and Issue 2 are qualifying debt instruments. Z has met the identification requirements by identifying Issue 1 as the qualifying debt instrument and Issue 2 as the §1.1275–6 hedge. The other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument.* The synthetic debt instrument has an issue price of $2,000, provides for a payment at maturity of $2,000, and, in addition, provides for annual payments of $140. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument's stated redemption price at maturity is $3,400 (the sum of all amounts to be paid on the qualifying debt instrument and the §1.1275–6 hedge, reduced by amounts to be received on the §1.1275–6 hedge other than the $1,000 payment received on the issue date). The synthetic debt instrument, therefore, has $1,400 of OID.

Example 7. Integrated transaction entered into by a foreign person. (i) *Facts.* X, a foreign person, enters into an integrated transaction by purchasing a qualifying debt instrument that pays U.S. source interest and entering into a notional principal contract with a U.S. corporation. Neither the income from

the qualifying debt instrument nor the income from the notional principal contract is effectively connected with a U.S. trade or business. The notional principal contract is a §1.1275–6 hedge.

(ii) *Treatment of integrated transaction.* Under paragraph (f)(8) of this section, X will receive U.S. source income from the integrated transaction. However, under paragraph (f)(12)(i) of this section, the qualifying debt instrument and the notional principal contract are treated as if they are not part of an integrated transaction for purposes of determining whether tax is due and must be withheld on income. Accordingly, because the §1.1275–6 hedge would produce foreign source income under §1.863–7 to X if it were not part of an integrated transaction, any income on the §1.1275–6 hedge generally will not be subject to tax under sections 871(a) and 881, and the U.S. corporation that is the counterparty will not be required to withhold tax on payments under the §1.1275–6 hedge under sections 1441 and 1442.

(i) [Reserved]

(j) *Effective date.* This section applies to a qualifying debt instrument issued on or after August 13, 1996. This section also applies to a qualifying debt instrument acquired by the taxpayer on or after August 13, 1996, if—

(1) The qualifying debt instrument is a fixed rate debt instrument or a variable rate debt instrument; or

(2) The qualifying debt instrument and the §1.1275–6 hedge are acquired by the taxpayer substantially contemporaneously.

[T.D. 8674, 61 FR 30155, June 14, 1996]

§ 1.1275–7 Inflation-indexed debt instruments.

(a) *Overview.* This section provides rules for the Federal income tax treatment of an inflation-indexed debt instrument. If a debt instrument is an inflation-indexed debt instrument, one of two methods will apply to the instrument: the coupon bond method (as described in paragraph (d) of this section) or the discount bond method (as described in paragraph (e) of this section). Both methods determine the amount of OID that is taken into account each year by a holder or an issuer of an inflation-indexed debt instrument.

(b) *Applicability*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, this section applies to an inflation-indexed debt instrument as

defined in paragraph (c)(1) of this section. For example, this section applies to Treasury Inflation-Protected Securities (TIPS).

(2) *Exceptions.* This section does not apply to an inflation-indexed debt instrument that is also—

(i) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (for example, U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations); or

(ii) A debt instrument subject to section 529 (certain debt instruments issued by qualified state tuition programs).

(c) *Definitions.* The following definitions apply for purposes of this section:

(1) *Inflation-indexed debt instrument.* An inflation-indexed debt instrument is a debt instrument that satisfies the following conditions:

(i) *Issued for cash.* The debt instrument is issued for U.S. dollars and all payments on the instrument are denominated in U.S. dollars.

(ii) *Indexed for inflation and deflation.* Except for a minimum guarantee payment (as defined in paragraph (c)(5) of this section), each payment on the debt instrument is indexed for inflation and deflation. A payment is indexed for inflation and deflation if the amount of the payment is equal to—

(A) The amount that would be payable if there were no inflation or deflation over the term of the debt instrument, multiplied by

(B) A ratio, the numerator of which is the value of the reference index for the date of the payment and the denominator of which is the value of the reference index for the issue date.

(iii) *No other contingencies.* No payment on the debt instrument is subject to a contingency other than the inflation contingency or the contingencies described in this paragraph (c)(1)(iii). A debt instrument may provide for—

(A) A minimum guarantee payment as defined in paragraph (c)(5) of this section; or

(B) Payments under one or more alternate payment schedules if the payments under each payment schedule are indexed for inflation and deflation and a payment schedule for the debt instrument can be determined under

§ 1.1272–1(c). (For purposes of this section, the rules of § 1.1272–1(c) are applied to the debt instrument by assuming that no inflation or deflation will occur over the term of the instrument.)

(2) *Reference index.* The reference index is an index used to measure inflation and deflation over the term of a debt instrument. To qualify as a reference index, an index must satisfy the following conditions:

(i) The value of the index is reset once a month to a current value of a single qualified inflation index (as defined in paragraph (c)(3) of this section). For this purpose, a value of a qualified inflation index is current if the value has been updated and published within the preceding six month period.

(ii) The reset occurs on the same day of each month (the reset date).

(iii) The value of the index for any date between reset dates is determined through straight-line interpolation.

(3) *Qualified inflation index.* A qualified inflation index is a general price or wage index that is updated and published at least monthly by an agency of the United States Government (for example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), which is published by the Bureau of Labor Statistics of the Department of Labor).

(4) *Inflation-adjusted principal amount.* For any date, the inflation-adjusted principal amount of an inflation-indexed debt instrument is an amount equal to—

(i) The outstanding principal amount of the debt instrument (determined as if there were no inflation or deflation over the term of the instrument), multiplied by

(ii) A ratio, the numerator of which is the value of the reference index for the date and the denominator of which is the value of the reference index for the issue date.

(5) *Minimum guarantee payment.* In general, a minimum guarantee payment is an additional payment made at maturity on a debt instrument if the total amount of inflation-adjusted principal paid on the instrument is less than the instrument's stated principal amount. The amount of the additional

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payment must be no more than the excess, if any, of the debt instrument's stated principal amount over the total amount of inflation-adjusted principal paid on the instrument. An additional payment is not a minimum guarantee payment unless the qualified inflation index used to determine the reference index is either the CPI-U or an index designated for this purpose by the Commissioner in the FEDERAL REGISTER or the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter). See paragraph (f)(4) of this section for the treatment of a minimum guarantee payment.

(d) *Coupon bond method*—(1) *In general.* This paragraph (d) describes the method (coupon bond method) to be used to account for qualified stated interest and inflation adjustments (OID) on an inflation-indexed debt instrument described in paragraph (d)(2) of this section.

(2) *Applicability.* The coupon bond method applies to an inflation-indexed debt instrument that satisfies the following conditions:

(i) *Issued at par.* A debt instrument is issued at par if the difference between its issue price and principal amount for the issue date is less than the de minimis amount. For this purpose, the de minimis amount is determined using the principles of §1.1273–1(d). See paragraph (g)(2) of this section, however, for the treatment of TIPS issued with more than a de minimis amount of premium.

(ii) *All stated interest is qualified stated interest.* All stated interest on the debt instrument is qualified stated interest. For purposes of this paragraph (d), stated interest is qualified stated interest if the interest is unconditionally payable in cash, or is constructively received under section 451, at least annually at a single fixed rate. Stated interest is payable at a single fixed rate if the amount of each interest payment is determined by multiplying the inflation adjusted principal amount for the payment date by the single fixed rate.

(3) *Qualified stated interest.* Under the coupon bond method, qualified stated interest is taken into account under the taxpayer's regular method of accounting. The amount of accrued but unpaid qualified stated interest as of any date is determined by using the principles of §1.446–3(e)(2)(ii) (relating to notional principal contracts). For example, if the interval between interest payment dates spans two taxable years, a taxpayer using an accrual method of accounting determines the amount of accrued qualified stated interest for the first taxable year by reference to the inflation-adjusted principal amount at the end of the first taxable year.

(4) *Inflation adjustments*—(i) *Current accrual.* Under the coupon bond method, an inflation adjustment is taken into account for each taxable year in which the debt instrument is outstanding.

(ii) *Amount of inflation adjustment.* For any relevant period (such as the taxable year or the portion of the taxable year during which a taxpayer holds an inflation-indexed debt instrument), the amount of the inflation adjustment is equal to—

(A) The sum of the inflation-adjusted principal amount at the end of the period and the principal payments made during the period, minus

(B) The inflation-adjusted principal amount at the beginning of the period.

(iii) *Positive inflation adjustments.* A positive inflation adjustment is OID.

(iv) *Negative inflation adjustments.* A negative inflation adjustment is a deflation adjustment that is taken into account under the rules of paragraph (f)(1) of this section.

(5) *Example.* The following example illustrates the coupon bond method:

Example: (i) *Facts.* On October 15, 1997, X purchases at original issue, for $100,000, a debt instrument that is indexed for inflation and deflation. The debt instrument matures on October 15, 1999, has a stated principal amount of $100,000, and has a stated interest rate of 5 percent, compounded semiannually. The debt instrument provides that the principal amount is indexed to the CPI-U. Interest is payable on April 15 and October 15 of each year. The amount of each interest payment is determined by multiplying the inflation-adjusted principal amount for each interest payment date by the stated interest rate, adjusted for the length of the accrual period. The debt instrument provides for a single payment of the inflation-adjusted principal amount at maturity. In addition,

the debt instrument provides for an additional payment at maturity equal to the excess, if any, of $100,000 over the inflation-adjusted principal amount at maturity. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

(ii) *Indexing methodology.* The debt instrument provides that the inflation-adjusted principal amount for any day is determined by multiplying the principal amount of the instrument for the issue date by a ratio, the numerator of which is the value of the reference index for the day the inflation-adjusted principal amount is to be determined and the denominator of which is the value of the reference index for the issue date. The value of the reference index for the first day of a month is the value of the CPI-U for the third preceding month. The value of the reference index for any day other than the first day of a month is determined based on a straight-line interpolation between the value of the reference index for the first day of the month and the value of the reference index for the first day of the next month.

(iii) *Inflation-indexed debt instrument subject to the coupon bond method.* Under paragraph (c)(1) of this section, the debt instrument is an inflation-indexed debt instrument. Because there is no difference between the debt instrument's issue price ($100,000) and its principal amount for the issue date ($100,000) and because all stated interest is qualified stated interest, the coupon bond method applies to the instrument.

(iv) *Reference index values.* Assume the following table lists the relevant reference index values for 1997 through 1999:

Date	Reference index value
Oct. 15, 1997	100
Jan. 1, 1998	101
Apr. 15, 1998	103
Oct. 15, 1998	105
Jan. 1, 1999	99

(v) *Treatment of X in 1997.* X does not receive any payments of interest on the debt instrument in 1997. Therefore, X has no qualified stated interest income for 1997. X, however, must take into account the inflation adjustment for 1997. The inflation-adjusted principal amount for January 1, 1998, is $101,000 ($100,000 × 101/100). Therefore, the inflation adjustment for 1997 is $1,000, the inflation-adjusted principal amount for January 1, 1998 ($101,000) minus the principal amount for the issue date ($100,000). X includes the $1,000 inflation adjustment in income as OID in 1997.

(vi) *Treatment of X in 1998.* In 1998, X receives two payments of interest: On April 15, 1998, X receives a payment of $2,575 ($100,000 × 103/100 × .05/2), and on October 15, 1998, X receives a payment of $2,625 ($100,000 × 105/100 × .05/2). Therefore, X's qualified stated interest

income for 1998 is $5,200 ($2,575 + $2,625). X also must take into account the inflation adjustment for 1998. The inflation-adjusted principal amount for January 1, 1999, is $99,000 ($100,000 × 99/100). Therefore, the inflation adjustment for 1998 is negative $2,000, the inflation-adjusted principal amount for January 1, 1999 ($99,000) minus the inflation-adjusted principal amount for January 1, 1998 ($101,000). Because the amount of the inflation adjustment is negative, it is a deflation adjustment. Under paragraph (f)(1)(i) of this section, X uses this $2,000 deflation adjustment to reduce the interest otherwise includible in income by X with respect to the debt instrument in 1998. Therefore, X includes $3,200 in income for 1998, the qualified stated interest income for 1998 ($5,200) minus the deflation adjustment ($2,000).

(e) *Discount bond method*—(1) *In general.* This paragraph (e) describes the method (discount bond method) to be used to account for OID on an inflation-indexed debt instrument that does not qualify for the coupon bond method.

(2) *No qualified stated interest.* Under the discount bond method, no interest on an inflation-indexed debt instrument is qualified stated interest.

(3) *OID.* Under the discount bond method, the amount of OID that accrues on an inflation-indexed debt instrument is determined as follows:

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield of the debt instrument is determined under the rules of § 1.1272–1(b)(1)(i). In calculating the yield under those rules for purposes of this paragraph (e)(3)(i), the payment schedule of the debt instrument is determined as if there were no inflation or deflation over the term of the instrument.

(ii) *Step two: Determine the accrual periods.* The accrual periods are determined under the rules of § 1.1272–1(b)(1)(ii). However, no accrual period can be longer than 1 month.

(iii) *Step three: Determine the percentage change in the reference index during the accrual period.* The percentage change in the reference index during the accrual period is equal to—

(A) The ratio of the value of the reference index at the end of the period to the value of the reference index at the beginning of the period,

(B) Minus one.

(iv) *Step four: Determine the OID allocable to each accrual period.* The OID allocable to an accrual period (n) is determined by using the following formula:

$$OID_{(n)} = AIP_{(n)} \times [r + inf_{(n)} + (r \times inf_{(n)})]$$

in which,

r = yield of the debt instrument as determined under paragraph (e)(3)(i) of this section (adjusted for the length of the accrual period);

$inf_{(n)}$ = percentage change in the value of the reference index for period (n) as determined under paragraph (e)(3)(iii) of this section; and

$AIP_{(n)}$ = adjusted issue price at the beginning of period (n).

(v) *Step five: Determine the daily portions of OID.* The daily portions of OID are determined and taken into account under the rules of § 1.1272–1(b)(1)(iv). If the daily portions determined under this paragraph (e)(3)(v) are negative amounts, however, these amounts (deflation adjustments) are taken into account under the rules for deflation adjustments described in paragraph (f)(1) of this section.

(4) *Example.* The following example illustrates the discount bond method:

Example: (i) *Facts.* On November 15, 1997, X purchases at original issue, for $91,403, a zero-coupon debt instrument that is indexed for inflation and deflation. The principal amount of the debt instrument for the issue date is $100,000. The debt instrument provides for a single payment on November 15, 2000. The amount of the payment will be determined by multiplying $100,000 by a fraction, the numerator of which is the CPI-U for September 2000, and the denominator of which is the CPI-U for September 1997. The debt instrument also provides that in no event will the payment on November 15, 2000, be less than $100,000. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

(ii) *Inflation-indexed debt instrument.* Under paragraph (c)(1) of this section, the instrument is an inflation-indexed debt instrument. The debt instrument's principal amount for the issue date ($100,000) exceeds its issue price ($91,403) by $8,597, which is more than the de minimis amount for the debt instrument ($750). Therefore, the coupon bond method does not apply to the debt instrument. As a result, the discount bond method applies to the debt instrument.

(iii) *Yield and accrual period.* Assume X chooses monthly accrual periods ending on the 15th day of each month. The yield of the debt instrument is determined as if there were no inflation or deflation over the term of the instrument. Therefore, based on the issue price of $91,403 and an assumed payment at maturity of $100,000, the yield of the debt instrument is 3 percent, compounded monthly.

(iv) *Percentage change in reference index.* Assume that the CPI-U for September 1997 is 160; for October 1997 is 161.2; and for November 1997 is 161.7. The value of the reference index for November 15, 1997, is 160, the value of the CPI-U for September 1997. Similarly, the value of the reference index for December 15, 1997, is 161.2, and for January 15, 1998, is 161.7. The percentage change in the reference index from November 15, 1997, to December 15, 1997, (inf_1) is 0.0075 (161.2/160–1); the percentage change in the reference index from December 15, 1997, to January 15, 1998, (inf_2) is 0.0031 (161.7/161.2–1).

(v) *Treatment of X in 1997.* For the accrual period ending on December 15, 1997, r is .0025 (.03/12), inf_1 is .0075, and the product of r and inf_1 is .00001875. Under paragraph (e)(3) of this section, the amount of OID allocable to the accrual period ending on December 15, 1997, is $916. This amount is determined by multiplying the issue price of the debt instrument ($91,403) by .01001875 (the sum of r, inf_1, and the product of r and inf_1). The adjusted issue price of the debt instrument on December 15, 1997, is $92,319 ($91,403 + $916). For the accrual period ending on January 15, 1998, r is .0025 (.03/12), inf_2 is .0031, and the product of r and inf_2 is .00000775. Under paragraph (e)(3) of this section, the amount of OID allocable to the accrual period ending on January 15, 1998, is $518. This amount is determined by multiplying the adjusted issue price of the debt instrument ($92,319) by .00560775 (the sum of r, inf_2, and the product of r and inf_2). Because the accrual period ending on January 15, 1998, spans two taxable years, only $259 of this amount ($518/30 days × 15 days) is allocable to 1997. Therefore, X includes $1,175 of OID in income for 1997 ($916 + $259).

(f) *Special rules.* The following rules apply to an inflation-indexed debt instrument:

(1) *Deflation adjustments*—(i) *Holder.* A deflation adjustment reduces the amount of interest otherwise includible in income by a holder with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(i), interest includes OID, qualified stated interest, and market discount. If the amount of the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year, the excess is treated as an ordinary loss by the holder for the

taxable year. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year and the amount treated as an ordinary loss for the taxable year, this excess is carried forward to reduce the amount of interest otherwise includible in income by the holder with respect to the debt instrument for subsequent taxable years.

(ii) *Issuer.* A deflation adjustment reduces the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(ii), interest includes OID and qualified stated interest. If the amount of the deflation adjustment exceeds the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year, the excess is treated as ordinary income by the issuer for the taxable year. However, the amount treated as ordinary income is limited to the amount by which the issuer's total interest deductions on the debt instrument in prior taxable years exceed the total amount treated by the issuer as ordinary income on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise deductible by the issuer with respect to the debt instrument for the taxable year and the amount treated as ordinary income for the taxable year, this excess is carried forward to reduce the interest otherwise deductible by the issuer with respect to the debt instrument for subsequent taxable years. If there is any excess remaining upon the retirement of the debt instrument, the issuer takes the excess amount into account as ordinary income.

(2) *Adjusted basis.* A holder's adjusted basis in an inflation-indexed debt instrument is determined under §1.1272–1(g). However, a holder's adjusted basis in the debt instrument is decreased by the amount of any deflation adjustment the holder takes into account to

reduce the amount of interest otherwise includible in income or treats as an ordinary loss with respect to the instrument during the taxable year. The decrease occurs when the deflation adjustment is taken into account under paragraph (f)(1) of this section.

(3) *Subsequent holders.* A holder determines the amount of acquisition premium or market discount on an inflation-indexed debt instrument by reference to the adjusted issue price of the instrument on the date the holder acquires the instrument. A holder determines the amount of bond premium on an inflation-indexed debt instrument by assuming that the amount payable at maturity on the instrument is equal to the instrument's inflation-adjusted principal amount for the day the holder acquires the instrument. Any premium or market discount is taken into account over the remaining term of the debt instrument as if there were no further inflation or deflation. See section 171 for additional rules relating to the amortization of bond premium and sections 1276 through 1278 for additional rules relating to market discount.

(4) *Minimum guarantee.* Under both the coupon bond method and the discount bond method, a minimum guarantee payment is ignored until the payment is made. If there is a minimum guarantee payment, the payment is treated as interest on the date it is paid.

(5) *Temporary unavailability of a qualified inflation index.* Notwithstanding any other rule of this section, an inflation-indexed debt instrument may provide for a substitute value of the qualified inflation index if and when the publication of the value of the qualified inflation index is temporarily delayed. The substitute value may be determined by the issuer under any reasonable method. For example, if the CPI-U is not reported for a particular month, the debt instrument may provide that a substitute value may be determined by increasing the last reported value by the average monthly percentage increase in the qualified inflation index over the preceding twelve months. The use of a substitute value does not result in a reissuance of the debt instrument.

(g) *TIPS*—(1) *Reopenings.* For rules concerning a reopening of TIPS, see paragraphs (d)(2), (k)(3)(iii), and (k)(3)(v) of §1.1275–2.

(2) *TIPS issued with more than a de minimis amount of premium*—(i) *Coupon bond method.* Notwithstanding paragraph (d)(2)(i) of this section, the coupon bond method described in paragraph (d) of this section applies to TIPS issued with more than a de minimis amount of premium. For this purpose, the de minimis amount is determined using the principles of §1.1273–1(d).

(ii) *Example.* The following example illustrates the application of the bond premium rules to a TIPS issued with bond premium:

Example. (i) *Facts.* X, a calendar year taxpayer, purchases at original issuance TIPS with a stated principal amount of $100,000 and a stated interest rate of .125 percent, compounded semiannually. For purposes of this example, assume that the TIPS are issued in Year 1 on January 1, stated interest is payable on June 30 and December 31 of each year, and that the TIPS mature on December 31, Year 5. X pays $102,000 for the TIPS, which is the issue price for the TIPS as determined under §1.1275–2(d)(1). Assume that the inflation-adjusted principal amount for the first coupon in Year 1 is $101,225 (resulting in an interest payment of $63.27) and for the second coupon in Year 1 is $102,500 (resulting in an interest payment of $64.06). X elects to amortize bond premium under §1.171–4. (For simplicity, contrary to actual practice, the TIPS in this example were issued on the date with respect to which the calculation of the first coupon began.)

(ii) *Bond premium.* The stated interest on the TIPS is qualified stated interest under §1.1273–1(c). X acquired the TIPS with bond premium of $2,000 (basis of $102,000 minus the TIPS' stated principal amount of $100,000). *See* §§1.171–1(d), 1.171–3(b), and paragraph (f)(3) of this section. The $2,000 is more than the de minimis amount of premium for the TIPS of $1,250 (.0025 times the stated principal amount of the TIPS ($100,000) times the number of complete years to the TIPS' maturity (5 years)). Under paragraph (g)(2)(i) of this section, X must use the coupon bond method to determine X's income from the TIPS.

(iii) *Allocation of bond premium.* Under §1.171–3(b), the bond premium of $2,000 is allocable to each semiannual accrual period by assuming that there will be no inflation or deflation over the term of the TIPS. Moreover, for purposes of §1.171–2, the yield of the securities is determined by assuming that there will be no inflation or deflation over

their term. Based on this assumption, for purposes of section 171, the TIPS provide for semiannual interest payments of $62.50 and a $100,000 payment at maturity. As a result, the yield of the securities for purposes of section 171 is −0.2720 percent, compounded semiannually. Under §1.171–2, the bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period ($62.50 for each accrual period) over the product of the taxpayer's adjusted acquisition price at the beginning of the accrual period (determined without regard to any inflation or deflation) and the taxpayer's yield. Therefore, the $2,000 of bond premium is allocable to each semiannual accrual period in Year 1 as follows: $201.22 to the accrual period ending on June 30, Year 1 (the excess of the stated interest of $62.50 over ($102,000 × −0.002720/2)); and $200.95 to the accrual period ending on December 31, Year 1 (the excess of the stated interest of $62.50 over ($101,798.78 × −0.002720/2)). The adjusted acquisition price at the beginning of the accrual period ending on December 31, Year 1 is $101,798.78 (the adjusted acquisition price of $102,000 at the beginning of the accrual period ending on June 30, Year 1 reduced by the $201.22 of premium allocable to that accrual period).

(iv) *Income determined by applying the coupon bond method and the bond premium rules.* Under paragraph (d)(4) of this section, the application of the coupon bond method to the TIPS results in a positive inflation adjustment in Year 1 of $2,500, which is includible in X's income for Year 1. However, because X acquired the TIPS at a premium and elected to amortize the premium, the premium allocable to Year 1 will offset the income on the TIPS as follows: The premium allocable to the first accrual period of $201.22 first offsets the interest payable for that period of $63.27. The remaining $137.95 of premium is treated as a deflation adjustment that offsets the positive inflation adjustment. *See* §1.171–3(b). The premium allocable to the second accrual period of $200.95 first offsets the interest payable for that period of $64.06. The remaining $136.89 of premium is treated as a deflation adjustment that further offsets the positive inflation adjustment. As a result, X does not include in income any of the stated interest received in Year 1 and includes in Year 1 income only $2,225.16 of the positive inflation adjustment for Year 1 ($2,500 − $137.94 − $136.89).

(h) *Effective/applicability dates*—(1) *In general.* This section applies to an inflation-indexed debt instrument issued on or after January 6, 1997.

(2) *TIPS issued with more than a de minimis amount of premium.* Notwithstanding paragraph (h)(1) of this section, paragraph (g)(2) of this section applies to TIPS issued with more than

a de minimis amount of premium on or after April 8, 2011.

[T.D. 8709, 62 FR 618, Jan. 6, 1997. Redesignated by T.D. 8838, 64 FR 48547, Sept. 7, 1999, as amended by T.D. 8840, 64 FR 60343, Nov. 5, 1999; T.D. 8934, 66 FR 2817, Jan. 12, 2001; T.D. 9609, 78 FR 668, Jan. 4, 2013]

§ 1.1286–1 Tax treatment of certain stripped bonds and stripped coupons.

(a) *De minimis OID.* If the original issue discount determined under section 1286(a) with respect to the purchase of a stripped bond or stripped coupon is less than the amount computed under subparagraphs (A) and (B) of section 1273(a)(3) and the regulations thereunder, then the amount of original issue discount with respect to that purchase (other than any tax-exempt portion thereof, determined under section 1286(d)(2)) shall be considered to be zero. For purposes of this computation, the number of complete years to maturity is measured from the date the stripped bond or stripped coupon is purchased.

(b) *Treatment of certain stripped bonds as market discount bonds*—(1) *In general.* By publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of the Statement of Procedural Rules), the Internal Revenue Service may (subject to the limitation of paragraph (b)(2) of this section) provide that certain mortgage loans that are stripped bonds are to be treated as market discount bonds under section 1278. Thus, any purchaser of such a bond is to account for any discount on the bond as market discount rather than original issue discount.

(2) *Limitation.* This treatment may be provided for a stripped bond only if, immediately after the most recent disposition referred to in section 1286(b)—

(i) The amount of original issue discount with respect to the stripped bond is determined under paragraph (a) of this section (concerning *de minimis* OID); or

(ii) The annual stated rate of interest payable on the stripped bond is no more than 100 basis points lower than the annual stated rate of interest payable on the original bond from which it and any other stripped bond or bonds and any stripped coupon or coupons were stripped.

(c) *Effective date.* This section is effective on and after August 8, 1991.

[T.D. 8463, 57 FR 61812, Dec. 29, 1992]

§ 1.1286–2 Stripped inflation-protected debt instruments.

Stripped inflation-protected debt instruments. If a Treasury Inflation-Protected Security is stripped under the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program, the holders of the principal and coupon components must use the discount bond method (as described in § 1.1275–7(e)) to account for the original issue discount on the components.

[T.D. 8709, 62 FR 621, Jan. 6, 1997. Redesignated by T.D. 8838, 64 FR 48547, Sept. 7, 1999; T.D. 9609, 78 FR 668, Jan. 4, 2013]

§ 1.1287–1 Denial of capital gains treatment for gains on registration-required obligations not in registered form.

(a) *In general.* Except as provided in paragraph (c) of this section, any gain on the sale or other disposition of a registration-required obligation held after December 31, 1982, that is not in registered form shall be treated as ordinary income unless the issuance of the obligation was subject to tax under section 4701. The term *registration-required obligation* has the meaning given to that term in section 163(f)(2), except that clause (iv) of subparagraph (A) thereof shall not apply. Therefore, although an obligation that is not in registered form is described in § 1.163–5(c)(1), the holder of such an obligation shall be required to treat the gain on the sale or other disposition of such obligation as ordinary income. The term *holder* means the person that would be denied a loss deduction under section 165(j)(1) or denied capital gain treatment under section 1287(a).

(b) *Registered form*—(1) *Obligations issued after September 21, 1984.* With respect to any obligation originally issued after September 21, 1984, the term *registered form* has the meaning given that term in section 103(j)(3) and the regulations thereunder. Therefore, an obligation that would otherwise be in registered form is not considered to