

(2) appropriate adjustments shall be made to the basis of any property to reflect gain recognized under subsection (a).

(Added Pub. L. 98-369, div. A, title I, § 41(a), July 18, 1984, 98 Stat. 543; amended Pub. L. 99-514, title VI, § 631(e)(15), title XVIII, §§ 1803(a)(5), (13)(A), 1899A(28), Oct. 22, 1986, 100 Stat. 2275, 2793, 2796, 2960; Pub. L. 100-647, title I, § 1018(u)(46), Nov. 10, 1988, 102 Stat. 3592; Pub. L. 103-66, title XIII, § 13206(b)(1)(A), (2)(B)(i), Aug. 10, 1993, 107 Stat. 465; Pub. L. 115-141, div. U, title IV, § 401(a)(180), Mar. 23, 2018, 132 Stat. 1193.)

Editorial Notes

AMENDMENTS

2018—Subsec. (a)(4). Pub. L. 115-141 substituted “871(a),” for “871(a),”.

1993—Subsec. (a)(4). Pub. L. 103-66, § 13206(b)(2)(B)(i), substituted “sections 103, 871(a),” for “sections 871(a).”

Subsec. (e). Pub. L. 103-66, § 13206(b)(1)(A), struck out heading and text of subsec. (e). Text read as follows: “This section shall not apply to any market discount bond issued on or before July 18, 1984.”

1988—Subsec. (b)(3). Pub. L. 100-647 designated paragraph relating to special rule where there are partial principal payments as par. (3) and inserted period at end.

1986—Subsec. (a)(3). Pub. L. 99-514, § 1803(a)(13)(A)(i), added par. (3). Former par. (3) redesignated (4).

Subsec. (a)(4). Pub. L. 99-514, § 1803(a)(13)(A)(i), (ii), redesignated par. (3) as (4) and substituted “under paragraph (1) or (3)” for “under paragraph (1).”

Subsec. (b). Pub. L. 99-514, § 1803(a)(13)(A)(iii), added undesignated par. at end relating to special rule where partial principal payments.

Subsec. (c)(3). Pub. L. 99-514, § 631(e)(15), struck out reference to section 334(c).

Subsec. (d)(1)(C). Pub. L. 99-514, § 1803(a)(5), added subpar. (C).

Subsec. (e). Pub. L. 99-514, § 1899A(28), substituted “July 18, 1984” for “the date of the enactment of this section”.

Statutory Notes and Related Subsidiaries

EFFECTIVE DATE OF 1993 AMENDMENT

Pub. L. 103-66, title XIII, § 13206(b)(3), Aug. 10, 1993, 107 Stat. 465, provided that: “The amendments made by this section [probably should be “subsection”, which amended this section and sections 1277 and 1278 of this title] shall apply to obligations purchased (within the meaning of section 1272(d)(1) of the Internal Revenue Code of 1986) after April 30, 1993.”

EFFECTIVE DATE OF 1988 AMENDMENT

Amendment by Pub. L. 100-647 effective, except as otherwise provided, as if included in the provision of the Tax Reform Act of 1986, Pub. L. 99-514, to which such amendment relates, see section 1019(a) of Pub. L. 100-647, set out as a note under section 1 of this title.

EFFECTIVE DATE OF 1986 AMENDMENT

Amendment by section 631(e)(15) of Pub. L. 99-514 applicable to any distribution in complete liquidation, and any sale or exchange, made by a corporation after July 31, 1986, unless such corporation is completely liquidated before Jan. 1, 1987, any transaction described in section 338 of this title for which the acquisition date occurs after Dec. 31, 1986, and any distribution, not in complete liquidation, made after Dec. 31, 1986, with exceptions and special and transitional rules, see section 633 of Pub. L. 99-514, set out as an Effective Date note under section 336 of this title.

Amendment by section 1803(a)(5) of Pub. L. 99-514 effective, except as otherwise provided, as if included in

the provisions of the Tax Reform Act of 1984, Pub. L. 98-369, div. A, to which such amendment relates, see section 1881 of Pub. L. 99-514, set out as a note under section 48 of this title.

Pub. L. 99-514, title XVIII, § 1803(a)(13)(C), Oct. 22, 1986, 100 Stat. 2797, provided that: “The amendments made by this paragraph [amending this section and section 1286 of this title] shall apply to obligations acquired after the date of the enactment of this Act [Oct. 22, 1986].”

EFFECTIVE DATE

Section applicable to taxable years ending after July 18, 1984, and applicable to obligations issued after July 18, 1984, in taxable years ending after such date, see section 44 of Pub. L. 98-369, set out as a note under section 1271 of this title.

PLAN AMENDMENTS NOT REQUIRED UNTIL JANUARY 1, 1989

For provisions directing that if any amendments made by subtitle A or subtitle C of title XI [§§ 1101-1147 and 1171-1177] or title XVIII [§§ 1800-1899A] of Pub. L. 99-514 require an amendment to any plan, such plan amendment shall not be required to be made before the first plan year beginning on or after Jan. 1, 1989, see section 1140 of Pub. L. 99-514, as amended, set out as a note under section 401 of this title.

§ 1277. Deferral of interest deduction allocable to accrued market discount

(a) General rule

Except as otherwise provided in this section, the net direct interest expense with respect to any market discount bond shall be allowed as a deduction for the taxable year only to the extent that such expense exceeds the portion of the market discount allocable to the days during the taxable year on which such bond was held by the taxpayer (as determined under the rules of section 1276(b)).

(b) Disallowed deduction allowed for later years

(1) Election to take into account in later year where net interest income from bond

(A) In general

If—

(i) there is net interest income for any taxable year with respect to any market discount bond, and

(ii) the taxpayer makes an election under this subparagraph with respect to such bond,

any disallowed interest expense with respect to such bond shall be treated as interest paid or accrued by the taxpayer during such taxable year to the extent such disallowed interest expense does not exceed the net interest income with respect to such bond.

(B) Determination of disallowed interest expense

For purposes of subparagraph (A), the amount of the disallowed interest expense—

(i) shall be determined as of the close of the preceding taxable year, and

(ii) shall not include any amount previously taken into account under subparagraph (A).

(C) Net interest income

For purposes of this paragraph, the term “net interest income” means the excess of

the amount determined under paragraph (2) of subsection (c) over the amount determined under paragraph (1) of subsection (c).

(2) Remainder of disallowed interest expense allowed for year of disposition

(A) In general

Except as otherwise provided in this paragraph, the amount of the disallowed interest expense with respect to any market discount bond shall be treated as interest paid or accrued by the taxpayer in the taxable year in which such bond is disposed of.

(B) Nonrecognition transactions

If any market discount bond is disposed of in a nonrecognition transaction—

- (i) the disallowed interest expense with respect to such bond shall be treated as interest paid or accrued in the year of disposition only to the extent of the amount of gain recognized on such disposition, and
- (ii) the disallowed interest expense with respect to such property (to the extent not so treated) shall be treated as disallowed interest expense—

(I) in the case of a transaction described in section 1276(c)(1), of the transferee with respect to the transferred basis property, or

(II) in the case of a transaction described in section 1276(c)(2), with respect to the exchanged basis property.

(C) Disallowed interest expense reduced for amounts previously taken into account under paragraph (1)

For purposes of this paragraph, the amount of the disallowed interest expense shall not include any amount previously taken into account under paragraph (1).

(3) Disallowed interest expense

For purposes of this subsection, the term “disallowed interest expense” means the aggregate amount disallowed under subsection (a) with respect to the market discount bond.

(c) Net direct interest expense

For purposes of this section, the term “net direct interest expense” means, with respect to any market discount bond, the excess (if any) of—

- (1) the amount of interest paid or accrued during the taxable year on indebtedness which is incurred or continued to purchase or carry such bond, over
- (2) the aggregate amount of interest (including original issue discount) includible in gross income for the taxable year with respect to such bond.

In the case of any financial institution which is a bank (as defined in section 585(a)(2)), the determination of whether interest is described in paragraph (1) shall be made under principles similar to the principles of section 291(e)(1)(B)(ii). Under rules similar to the rules of section 265(a)(5), short sale expenses shall be treated as interest for purposes of determining net direct interest expense.

(Added Pub. L. 98-369, div. A, title I, §41(a), July 18, 1984, 98 Stat. 545; amended Pub. L. 99-514,

title IX, §§901(d)(4)(F), §902(e)(2), title XVIII, §1899A(29)–(31), Oct. 22, 1986, 100 Stat. 2380, 2382, 2960; Pub. L. 100-647, title I, §1018(u)(31), Nov. 10, 1988, 102 Stat. 3592; Pub. L. 103-66, title XIII, §13206(b)(1)(B), Aug. 10, 1993, 107 Stat. 465; Pub. L. 104-188, title I, §1616(b)(14), Aug. 20, 1996, 110 Stat. 1857.)

Editorial Notes

AMENDMENTS

1996—Subsec. (c). Pub. L. 104-188 struck out “or to which section 593 applies” after “585(a)(2)” in closing provisions.

1993—Subsec. (d). Pub. L. 103-66 struck out heading and text of subsec. (d). Text read as follows: “In the case of a market discount bond issued on or before July 18, 1984, any gain recognized by the taxpayer on any disposition of such bond shall be treated as ordinary income to the extent the amount of such gain does not exceed the amount allowable with respect to such bond under subsection (b)(2) for the taxable year in which such bond is disposed of.”

1988—Subsec. (c). Pub. L. 100-647 inserted a closing parenthesis after “section 585(a)(2)”.

1986—Subsec. (b)(1)(C). Pub. L. 99-514, §1899A(29), substituted “this paragraph” for “this paragraph”.

Subsec. (b)(2)(C). Pub. L. 99-514, §1899A(30), substituted “paragraph (1)” for “paragraph 1” in heading.

Subsec. (c). Pub. L. 99-514, §901(d)(4)(F), substituted “which is a bank (as defined in section 585(a)(2) or to which section 593 applies” for “to which section 585 or 593 applies”.

Pub. L. 99-514, §902(e)(2), substituted “section 265(a)(5)” for “section 265(5)”.

Subsec. (d). Pub. L. 99-514, §1899A(31), substituted “July 18, 1984” for “the date of the enactment of this section”.

Statutory Notes and Related Subsidiaries

EFFECTIVE DATE OF 1996 AMENDMENT

Amendment by Pub. L. 104-188 applicable to taxable years beginning after Dec. 31, 1995, see section 1616(c) of Pub. L. 104-188, set out as a note under section 593 of this title.

EFFECTIVE DATE OF 1993 AMENDMENT

Amendment by Pub. L. 103-66 applicable to obligations purchased (within the meaning of section 1272(d)(1) [now 1272(c)(1)] of this title) after Apr. 30, 1993, see section 13206(b)(3) of Pub. L. 103-66, set out as a note under section 1276 of this title.

EFFECTIVE DATE OF 1988 AMENDMENT

Amendment by Pub. L. 100-647 effective, except as otherwise provided, as if included in the provision of the Tax Reform Act of 1986, Pub. L. 99-514, to which such amendment relates, see section 1019(a) of Pub. L. 100-647, set out as a note under section 1 of this title.

EFFECTIVE DATE OF 1986 AMENDMENT

Amendment by section 901(d)(4)(F) of Pub. L. 99-514 applicable to taxable years beginning after Dec. 31, 1986, see section 901(e) of Pub. L. 99-514, set out as a note under section 166 of this title.

Amendment by section 902(e)(2) of Pub. L. 99-514 applicable to taxable years ending after Dec. 31, 1986, with certain exceptions and qualifications, see section 902(f) of Pub. L. 99-514, set out as a note under section 265 of this title.

EFFECTIVE DATE

Section applicable to taxable years ending after July 18, 1984, and applicable to obligations acquired after July 18, 1984, in taxable years ending after such date, see section 44 of Pub. L. 98-369, set out as a note under section 1271 of this title.

PLAN AMENDMENTS NOT REQUIRED UNTIL
JANUARY 1, 1989

For provisions directing that if any amendments made by subtitle A or subtitle C of title XI [§§ 1101-1147 and 1171-1177] or title XVIII [§§ 1800-1899A] of Pub. L. 99-514 require an amendment to any plan, such plan amendment shall not be required to be made before the first plan year beginning on or after Jan. 1, 1989, see section 1140 of Pub. L. 99-514, as amended, set out as a note under section 401 of this title.

§ 1278. Definitions and special rules

(a) In general

For purposes of this part—

(1) Market discount bond

(A) In general

Except as provided in subparagraph (B), the term “market discount bond” means any bond having market discount.

(B) Exceptions

The term “market discount bond” shall not include—

(i) Short-term obligations

Any obligation with a fixed maturity date not exceeding 1 year from the date of issue.

(ii) United States savings bonds

Any United States savings bond.

(iii) Installment obligations

Any installment obligation to which section 453B applies.

(C) Section 1277 not applicable to tax-exempt obligations

For purposes of section 1277, the term “market discount bond” shall not include any tax-exempt obligation (as defined in section 1275(a)(3)).

(D) Treatment of bonds acquired at original issue

(i) In general

Except as otherwise provided in this subparagraph or in regulations, the term “market discount bond” shall not include any bond acquired by the taxpayer at its original issue.

(ii) Treatment of bonds acquired for less than issue price

Clause (i) shall not apply to any bond if—

(I) the basis of the taxpayer in such bond is determined under section 1012, and

(II) such basis is less than the issue price of such bond determined under subpart A of this part.

(iii) Bonds acquired in certain reorganizations

Clause (i) shall not apply to any bond issued pursuant to a plan of reorganization (within the meaning of section 368(a)(1)) in exchange for another bond having market discount. Solely for purposes of section 1276, the preceding sentence shall not apply if such other bond was issued on or

before July 18, 1984 (the date of the enactment of section 1276) and if the bond issued pursuant to such plan of reorganization has the same term and the same interest rate as such other bond had.

(iv) Treatment of certain transferred basis property

For purposes of clause (i), if the adjusted basis of any bond in the hands of the taxpayer is determined by reference to the adjusted basis of such bond in the hands of a person who acquired such bond at its original issue, such bond shall be treated as acquired by the taxpayer at its original issue.

(2) Market discount

(A) In general

The term “market discount” means the excess (if any) of—

(i) the stated redemption price of the bond at maturity, over

(ii) the basis of such bond immediately after its acquisition by the taxpayer.

(B) Coordination where bond has original issue discount

In the case of any bond having original issue discount, for purposes of subparagraph (A), the stated redemption price of such bond at maturity shall be treated as equal to its revised issue price.

(C) De minimis rule

If the market discount is less than $\frac{1}{4}$ of 1 percent of the stated redemption price of the bond at maturity multiplied by the number of complete years to maturity (after the taxpayer acquired the bond), then the market discount shall be considered to be zero.

(3) Bond

The term “bond” means any bond, debenture, note, certificate, or other evidence of indebtedness.

(4) Revised issue price

The term “revised issue price” means the sum of—

(A) the issue price of the bond, and

(B) the aggregate amount of the original issue discount includible in the gross income of all holders for periods before the acquisition of the bond by the taxpayer (determined without regard to section 1272(a)(7)) or, in the case of a tax-exempt obligation, the aggregate amount of the original issue discount which accrued in the manner provided by section 1272(a) (determined without regard to paragraph (7) thereof) during periods before the acquisition of the bond by the taxpayer.

(5) Original issue discount, etc.

The terms “original issue discount”, “stated redemption price at maturity”, and “issue price” have the respective meanings given such terms by subpart A of this part.

(b) Election to include market discount currently

(1) In general

If the taxpayer makes an election under this subsection—