

DEPARTMENT OF HEALTH AND HUMAN SERVICES**Food and Drug Administration****21 CFR Part 558****New Animal Drugs For Use In Animal Feeds; Virginiamycin**

AGENCY: Food and Drug Administration, HHS.

ACTION: Final rule.

SUMMARY: The Food and Drug Administration (FDA) is amending the animal drug regulations to reflect approval of a supplemental new animal drug application (NADA) filed by Pfizer Inc. The supplement provides for use of a 30% virginiamycin formulation of a Type A medicated article to be used for the manufacture of Type C medicated feeds for cattle fed in confinement for slaughter.

EFFECTIVE DATE: June 14, 1996.

FOR FURTHER INFORMATION CONTACT: Russell G. Arnold, Center for Veterinary Medicine (HFV-142), Food and Drug Administration, 7500 Standish Pl., Rockville, MD 20855, 301-594-1674.

SUPPLEMENTARY INFORMATION: Pfizer Inc., 235 East 42d St., New York, NY 10017, filed a supplement to NADA 140-998 which provided for use of a 30% virginiamycin Type A medicated article formulation to be used in a micro-ingredient production process for the preparation of Type C medicated feeds for cattle fed in confinement for slaughter. The Type C medicated feed is fed at 11 to 16 grams per ton (g/t) for improved feed efficiency, 13.5 to 16 g/t for reduction of incidence of liver abscesses, and 16 to 22.5 g/t for increased rate of weight gain. The feed is not for animals intended for breeding. The supplement is approved as of May 3, 1996, and the regulations are amended in 21 CFR 558.635(b) to reflect the approval.

Approval of this supplement does not require submission of new safety or effectiveness data. The supplement provides for use of an additional level of Type A medicated article to make a Type C medicated feed fed at previously approved levels and for previously approved conditions of use.

The agency has determined under 21 CFR 25.24(d)(1)(iii) that this action is of a type that does not individually or cumulatively have a significant effect on the human environment. Therefore, neither an environmental assessment nor an environmental impact statement is required.

Under section 512(c)(2)(F)(iii) of the Federal Food, Drug, and Cosmetic Act

(21 U.S.C. 360b(c)(2)(F)(iii)), this approval does not qualify for marketing exclusivity because reports of new clinical or field investigations (other than bioequivalence or residue studies) and, in the case of food producing animals, human food safety studies (other than bioequivalence or residue studies) essential to the approval and conducted or sponsored by the applicant were not required.

List of Subjects in 21 CFR Part 558

Animal drugs, Animal feeds.

Therefore, under the Federal Food, Drug, and Cosmetic Act and under authority delegated to the Commissioner of Food and Drugs and redelegated to the Center for Veterinary Medicine, 21 CFR part 558 is amended as follows:

PART 558—NEW ANIMAL DRUGS FOR USE IN ANIMAL FEEDS

1. The authority citation for 21 CFR part 558 continues to read as follows:

Authority: Secs. 512, 701 of the Federal Food, Drug, and Cosmetic Act (21 U.S.C. 360b, 371).

§ 558.635 [Amended]

2. Section 558.635 *Virginiamycin* is amended in paragraph (b)(1) by removing “to 000069” and by adding in its place “used as in paragraph (f) of this section; and 30 percent activity (136.2 grams per pound) for the manufacture of Type C medicated feed for cattle used as in paragraph (f)(3); to 000069”.

Dated: June 7, 1996.

Andrew J. Beaulieu,

Deputy Director, Office of New Animal Drug Evaluation, Center for Veterinary Medicine.

[FR Doc. 96-15202 Filed 6-13-96; 8:45 am]

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DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Parts 1 and 602**

[TD 8674]

RIN 1545-AQ86; 1545-AS35

Debt Instruments With Original Issue Discount; Contingent Payments; Anti-Abuse Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of debt instruments that provide for one or more contingent payments. This document also contains final regulations

that treat a debt instrument and a related hedge as an integrated transaction. In addition, this document contains amendments to the original issue discount regulations, and finalizes the anti-abuse rule relating to those regulations. The final regulations in this document provide needed guidance to holders and issuers of contingent payment debt instruments.

DATES: Except as noted below, the regulations are effective August 13, 1996. The amendments to § 1.1275-5 are effective June 14, 1996, except for paragraphs (a)(6), (b)(2), and (c)(1), which are effective August 13, 1996. The removal of § 1.483-2T is effective June 14, 1996. The removal of § 1.1275-2T is effective August 13, 1996.

For dates of applicability of these regulations, see Effective Dates under **SUPPLEMENTARY INFORMATION.**

FOR FURTHER INFORMATION CONTACT: Concerning the regulations (other than § 1.1275-6), William E. Blanchard, (202) 622-3950, or Jeffrey W. Maddrey, (202) 622-3940; or concerning § 1.1275-6, Michael S. Novey, (202) 622-3900 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:**Paperwork Reduction Act**

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1450. Responses to these collections of information are required to determine a taxpayer's interest income or deductions on a contingent payment debt instrument.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent/recordkeeper varies from .3 hours to .5 hours, depending on individual circumstances, with an estimated average of .47 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to the collections of information must be retained as long as their contents may become material in the administration

of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 1275(d) of the Internal Revenue Code (Code) grants the Secretary the authority to prescribe regulations under the original issue discount (OID) provisions of the Code (sections 163(e) and 1271 through 1275), including regulations relating to debt instruments that provide for contingent payments. On February 2, 1994, the IRS published final OID regulations in the Federal Register (59 FR 4799). However, the final OID regulations did not contain rules for contingent payment debt instruments.

On December 16, 1994, the IRS published a notice of proposed rulemaking in the Federal Register (59 FR 62884) relating to the tax treatment of debt instruments that provide for one or more contingent payments. The notice also contained proposed amendments to the regulations under sections 483 (relating to unstated interest), 1001 (relating to the amount realized on a sale, exchange, or other disposition of property), 1272 (relating to the accrual of OID), 1274 (relating to debt instruments issued for nonpublicly traded property), and 1275(c) (relating to OID information reporting requirements), and to § 1.1275-5 (relating to variable rate debt instruments). In addition, the notice contained proposed regulations relating to the integration of a contingent payment or variable rate debt instrument with a related hedge. The notice withdrew the proposed regulations relating to contingent payment debt instruments that were previously published in the Federal Register on April 8, 1986 (51 FR 12087), and February 28, 1991 (56 FR 8308).

On March 16, 1995, the IRS held a public hearing on the proposed regulations. In addition, the IRS received a number of written comments on the proposed regulations. The proposed regulations, with certain changes to respond to comments, are adopted as final regulations. In addition, certain clarifying and conforming amendments are made to the OID regulations that were published in the Federal Register on February 2, 1994. The comments and significant changes are discussed below.

Explanation of Provisions

Section 1.1275-4 Contingent Payment Debt Instruments

A. Noncontingent Bond Method

Under the noncontingent bond method in the proposed regulations, a taxpayer computes interest accruals on a contingent payment debt instrument by setting a payment schedule as of the issue date and applying the OID rules to the payment schedule. The payment schedule consists of all fixed payments on the debt instrument and a projected amount for each contingent payment. For market-based contingencies (i.e., contingencies for which price quotes are readily available), the projected amount is the forward price of the contingency. For other contingencies, the issuer first determines a reasonable yield for the debt instrument and then sets projected amounts equal to the relative expected payments on the contingencies so that the payment schedule produces the reasonable yield. These rules were designed to produce a yield similar to the yield the issuer would obtain on a fixed rate debt instrument.

Commentators suggested that the regulations could be simplified if they used the same basic methodology for both market-based and non-market-based contingencies. In addition, commentators suggested that forward price quotes would be variable or manipulable and that taxpayers will set more appropriate payment schedules if they first determine yield and then set the payment schedule to fit the yield.

The final regulations adopt these suggestions and generally conform the treatment of debt instruments that provide for either market-based or non-market-based contingent payments. Thus, for any contingent payment debt instrument subject to the noncontingent bond method, a taxpayer first determines the yield on the instrument and then sets the payment schedule to fit the yield. The yield is determined by the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to the contingent payment debt instrument (the comparable yield). Relevant terms and conditions include the level of subordination, term, timing of payments, and general market conditions. For example, if a hedge is available such that the issuer or holder could integrate the debt instrument and the hedge into a synthetic fixed-rate debt instrument under the rules of § 1.1275-6, the comparable yield is the yield that the synthetic fixed-rate debt instrument would have. If a § 1.1275-6 hedge (or the substantial equivalent) is

not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In all cases, the yield must be a reasonable yield for the issuer and may not be less than the applicable Federal rate (AFR).

Once the comparable yield is determined, the payment schedule is set to produce the comparable yield. The final regulations retain the general approach of the proposed regulations in determining the payment schedule. Thus, for market-based payments, the projected payment is the forward price of the payment. For non-market-based payments, the projected payment is the expected amount of the payment as of the issue date.

Commentators were concerned that a taxpayer could overstate the yield on a contingent payment debt instrument and, therefore, claim excess interest deductions during the term of the instrument. They were particularly concerned about a long-term debt instrument that has non-market-based payments because the taxpayer's determination would be hard to verify and any excess interest deductions would not be recaptured for a long time.

The final regulations address this concern by providing that the comparable yield for a debt instrument is presumed to be the AFR if the instrument provides for a non-market-based payment and is part of an issue that is marketed or sold in substantial part to tax-exempt investors or other investors for whom the treatment of the debt instrument is not expected to have a substantial effect on their U.S. tax liability. A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield that is higher than the AFR. Appraisals and other valuations of nonpublicly traded property cannot be used to overcome the presumption, nor can references to general market rates. An issuer may, for example, overcome the presumption by showing that recently issued similar debt instruments of the issuer trade at a price that reflects a specific yield.

One commentator suggested that the use of the term *projected payment schedule* caused securities law problems because the issuer could be seen as making representations to the holder about the expected payments. The comparable yield and projected payment schedule determined under these regulations are for tax purposes only and are not assurances by the

issuer with respect to the payments. The final regulations retain the term *projected payment schedule*, but an issuer may use a different term to describe the payment schedule (e.g., payment schedule determined under § 1.1275-4) if the language used by the issuer is clear.

Under the proposed regulations, projected payments rather than actual payments are used to determine the adjusted issue price of a debt instrument, the holder's basis in a debt instrument, and the amount of any contingent payment treated as made on the scheduled retirement of a debt instrument. One commentator questioned the use of projected payments to make these determinations. The approach in the proposed regulations is appropriate, however, because a positive or negative adjustment is used to take into account the difference between the actual amount and the projected amount of a contingent payment. This difference would be counted twice if the adjusted issue price, the holder's basis, and the amount deemed paid on retirement were based on the actual amount rather than the projected amount of a contingent payment. Thus, the approach used in the proposed regulations is retained in the final regulations.

B. Tax-Exempt Obligations

In response to comments, the rules contained in § 1.1275-4(d) relating to tax-exempt contingent payment obligations have been revised. Under the proposed regulations, tax-exempt obligations are generally subject to the noncontingent bond method, with the following modifications: (1) The yield on which interest accruals are based may not exceed the greater of the yield on the obligation, determined without regard to the non-market-based contingent payments, and the tax-exempt AFR that applies to the obligation; (2) Positive adjustments are treated as gain from the sale or exchange of the obligation rather than as interest; and (3) Negative adjustments reduce the amount of tax-exempt interest, and, therefore, are generally not taken into account as deductible losses. These modifications to the noncontingent bond method for tax-exempt obligations were added because the IRS and Treasury believe that when a property right is embedded in a tax-exempt obligation it is generally inappropriate to treat payments on the right as interest on an obligation of a state or political subdivision.

Several commentators suggested that the proposed regulations relating to tax-exempt obligations are overly

restrictive. These commentators questioned the reason for limiting the rate of accrual to the tax-exempt AFR and characterizing positive adjustments as taxable gain rather than interest. They also questioned the fairness of treating negative adjustments as nondeductible adjustments to tax-exempt interest when positive adjustments are treated as taxable gain. Some of the commentators suggested that, at a minimum, the interest limitations should not apply to contingent obligations that pay interest based on interest rate formulas that reflect the cost of funds rather than changes in the value of embedded property rights. Finally, commentators noted that programs involving municipal refinancings of real estate projects (for example, low-income multi-family housing projects) would be jeopardized by the proposed regulations because payments on tax-exempt obligations issued to finance these projects are in certain cases contingent in part on the revenues or appreciation in value of the project.

The IRS and Treasury continue to believe that gain from a property right should not be recharacterized as tax-exempt interest merely because the property right is embedded in a tax-exempt obligation. The IRS and Treasury nevertheless recognize that certain types of traditional tax-exempt financings should not be subject to the interest limitations of the proposed regulations (e.g., financings on which interest is computed in a manner that relates to the cost of funds). Accordingly, § 1.1275-4(d) has been revised to include a category of tax-exempt obligations that will be subject to the noncontingent bond method without the tax-exempt interest limitations contained in the proposed regulations. This category of tax-exempt obligations includes (1) obligations that would qualify as variable rate debt instruments (VRDIs) except for the failure to meet certain of the technical requirements of the VRDI definition (such as the cap and floor limitations, or the requirement that interest be paid or compounded at least annually), and (2) certain obligations issued to refinance an obligation, the proceeds of which were used to finance a project.

For other tax-exempt obligations, the interest restrictions of the proposed regulations are adopted in final form. Section 1.1275-4(d) has been revised, however, to provide that a negative adjustment is treated as a taxable loss from the sale or exchange of the obligation, rather than as a nondeductible adjustment to tax-exempt interest.

C. Prepaid Tuition Plans

A number of commentators asked whether contracts issued under state-sponsored prepaid tuition plans are subject to § 1.1275-4. Although the terms of the contracts vary, the contracts generally are issued pursuant to a plan created by a state to enable the participants in the plan to save for post-secondary education for themselves or other designated beneficiaries. In addition, the plans generally provide protection against increases in the costs of higher education or otherwise subsidize these costs, often by providing for contingent payments that are linked to the future costs of post-secondary education.

The commentators argue that § 1.1275-4 does not apply to the contracts because the contracts are not debt instruments for federal income tax purposes. In addition, the commentators argue that, even if the contracts are debt instruments, the noncontingent bond method would be unduly burdensome and inappropriate for contracts of this type.

The final regulations under § 1.1275-4 do not affect the treatment of contracts issued pursuant to state-sponsored prepaid tuition plans, whether or not the contracts are debt instruments. The final regulations, like the proposed regulations, only apply to debt instruments. Thus, the final regulations do not apply to contracts issued pursuant to a plan created by a state to enable participants to save for post-secondary education if the contracts are not debt instruments. In addition, the final regulations provide an exception for any debt instrument issued pursuant to a state-sponsored prepaid tuition plan.

This exception applies to a contract issued pursuant to a plan or arrangement if: The plan or arrangement is created by a state statute; the plan or arrangement has a primary objective of enabling the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and the contingencies under the contract are related to such purpose. These characteristics are intended to describe all existing state-sponsored prepaid tuition plans. Therefore, the final regulations do not change the tax treatment of a contract issued pursuant to these plans. As a result, if the contract is a debt instrument, the contingent payments on the contract are not taken into account by an individual until the payments are made.

The exception in the final regulations is intended to apply only to the existing

state-sponsored prepaid tuition plans and to any future plans that are substantially similar to the existing plans. In addition, no inference is intended as to whether contracts issued by any state-sponsored prepaid tuition plan are debt instruments.

D. Debt Instruments Subject to Section 1274

The proposed regulations provide a method for contingent payment debt instruments not subject to the noncontingent bond method (i.e., a nonpublicly traded debt instrument issued in a sale or exchange of nonpublicly traded property). Under the method, a debt instrument's noncontingent payments are treated as a separate debt instrument, which is generally taxed under the rules for noncontingent debt instruments. The debt instrument's contingent payments are taken into account when made. A portion of each contingent payment is treated as principal, based on the amount determined by discounting the payment at the AFR from the payment date to the issue date, and the remainder is treated as interest. Special rules are provided if a contingent payment becomes fixed more than 6 months before it is due.

The final regulations generally adopt the method in the proposed regulations. In addition, the final regulations contain rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (e.g., a subsequent holder).

E. Inflation-Indexed Bonds

The Treasury recently announced that it was considering issuing bonds indexed to inflation (61 FR 25164). Depending on their ultimate structure, the noncontingent bond method might be inappropriate for these bonds. If the Treasury issues these bonds, the Treasury and IRS may issue regulations to provide a simplified tax treatment for the bonds. The treatment would require current accrual of the inflation component.

Other Amendments to the OID Regulations

A. Alternative Payment Schedules Under § 1.1272-1(c)

Section 1.1272-1(c) provides rules to determine the yield and maturity of certain debt instruments that provide for one or more alternative payment schedules applicable upon the occurrence of a contingency (or contingencies), provided that the timing and amounts of the payments that comprise each payment schedule are

known as of the issue date. Under these rules, the yield and maturity of a debt instrument are generally determined by assuming that the payments will be made under the payment schedule most likely to occur (based on all the facts and circumstances as of the issue date). Special rules are provided for unconditional options and mandatory sinking funds.

The general rules in § 1.1272-1(c) produce a reasonable result when a debt instrument has one stated payment schedule that is very likely to occur and one or more alternative payment schedules that are unlikely to occur. In this case, adherence to the stated payment schedule will result in accruals on the debt instrument that reasonably reflect the expected return on the instrument. The rules can lead to unreasonable results, however, if a debt instrument provides for a stated payment schedule and one or more alternative payment schedules that differ significantly and that have a comparable likelihood of occurring. In this case, the accruals based on the payment schedule identified as most likely to occur could differ significantly from the expected return on the debt instrument, which would reflect all the payment schedules and their relative probabilities of occurrence.

Because the general rules of § 1.1272-1(c) could produce unreasonable results, these rules have been modified. Under the final regulations, if a single payment schedule is significantly more likely than not to occur, the yield and maturity of the debt instrument are calculated based on that payment schedule. As a result, any other debt instrument that provides for an alternative payment schedule (other than because of an unconditional option or mandatory sinking fund) will generally be subject to the rules in § 1.1275-4 for contingent payment debt instruments. The final regulations generally retain the rules for mandatory sinking funds and unconditional options.

B. Remote and Incidental Contingencies

The proposed regulations provide that a payment subject to a remote or incidental contingency is not considered a contingent payment for purposes of § 1.1275-4. In response to a comment, the rule relating to remote and incidental contingencies has been broadened, through the addition of new § 1.1275-2(h), to provide that remote and incidental contingencies are generally ignored for purposes of sections 163(e) (other than section 163(e)(5)) and 1271 through 1275 and the regulations thereunder. Thus, for example, if an otherwise fixed payment

debt instrument provides for an additional payment that will be made upon the occurrence of a contingency and there is a remote likelihood that the contingency will occur, the contingent payment is ignored for purposes of computing OID accruals on the instrument. If the contingency occurs, however, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as reissued. Therefore, OID on the debt instrument is redetermined.

C. Definition of Qualified Stated Interest

The addition of the rules for remote or incidental contingencies and the changes to the rules for alternative payment schedules allow simplification of the definition of qualified stated interest. Under § 1.1273-1(c), as published in the Federal Register on February 2, 1994, qualified stated interest must be unconditionally payable in cash or property at least annually at a single fixed rate. Interest is unconditionally payable only if late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment is expected to be penalized or reasonable remedies exist to compel payment.

This definition of unconditionally payable can be read to conflict with the alternative payment schedule rules. For example, if a debt instrument has two alternative payment schedules, one schedule can be stated as the required payment schedule and the other schedule can be stated as a penalty if the required payments are not made. The required payments might then be treated as unconditionally payable and, therefore, as being qualified stated interest even if they would not be qualified stated interest if treated under the alternative payment schedule rules. Under this treatment, if a payment is not made, the reissuance rules of the alternative payment schedule regime do not apply. Holders can thus argue that no OID would accrue with respect to the debt instrument even though OID would accrue if the instrument were treated as having an alternative payment schedule and holders fully expect any unmade payment to be made in the future.

The remote or incidental rules in § 1.1275-2(h) provide a better mechanism for determining whether a payment is qualified stated interest and determining the treatment if no payment is made. Thus, the final regulations modify the definition of unconditionally payable so that interest is unconditionally payable only if reasonable legal remedies exist to compel payment or the debt instrument otherwise provides terms and

conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment remote. If the payment is not made (other than because of insolvency, default, or similar circumstances), the final regulations require a deemed reissuance for OID purposes, which ensures that OID will accrue. This approach should simplify the treatment of many debt instruments and yet ensure that OID accrues in appropriate circumstances.

D. OID Anti-Abuse Rule

On February 2, 1994, the IRS published in the Federal Register temporary and proposed regulations that contained an anti-abuse rule for purposes of the OID regulations (§ 1.1275-2T (59 FR 4831); § 1.1275-2(g) (59 FR 4878)). Under the anti-abuse rule, the Commissioner can apply or depart from the regulations under section 163(e) or sections 1271 through 1275 as necessary to achieve a reasonable result if a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result under the regulations that is unreasonable in light of the applicable statutes. This rule is adopted as a final regulation with some clarifying changes and the addition of an example to illustrate its application to certain contingent payment debt instruments.

E. Determination of Issue Price Under Section 1274

Under the proposed regulations, the issue price of a contingent payment debt instrument that is subject to section 1274 (i.e., a debt instrument issued in exchange for nonpublicly traded property) is determined without taking into account the instrument's contingent payments. Thus, the issue price of the debt instrument (and the buyer's initial basis in the property) is limited to an amount determined by taking into account only the noncontingent payments. The buyer's basis in the property, however, is increased by the amount of a contingent payment treated as principal. This approach was adopted primarily because it is inappropriate to allow a buyer a basis in property that reflects anticipated contingent payments that are uncertain in amount. In addition, this approach limits the ability of the buyer to overstate interest deductions over the term of the debt instrument. The approach of the proposed regulations has been adopted in the final regulations for taxable debt instruments subject to section 1274. See § 1.1274-2(g).

It is not appropriate, however, to apply this approach to tax-exempt

contingent payment obligations subject to section 1274. Because the present value of projected contingent payments generally is not included in the issue price of a taxable debt instrument subject to section 1274, the instrument is accounted for under § 1.1275-4(c). This regime is not appropriate for tax-exempt obligations because it does not distinguish between tax-exempt interest and gain attributable to an embedded property right. Thus, in order to permit tax-exempt obligations to be subject to the noncontingent bond method under § 1.1275-4(b), the final regulations provide special rules to determine the issue price of a tax-exempt contingent payment obligation subject to section 1274.

Under these rules, the issue price of a tax-exempt contingent payment obligation subject to section 1274 is equal to the fair market value of the obligation on the issue date (or, in the case of an obligation that provides for interest-based or revenue-based payments, the greater of the obligation's fair market value or stated principal amount). In addition, the obligation is subject to the rules of § 1.1275-4(d) (the noncontingent bond method for tax-exempt contingent payment obligations) rather than § 1.1275-4(c). However, to ensure that the buyer's basis is the same as if the buyer had issued a taxable debt instrument, the final regulations limit the buyer's basis to the present value of the fixed payments.

Section 1.1275-6 Integration Rules

Commentators generally approved of the integration rules in the proposed regulations, and those rules are adopted with only two significant changes.

First, the final regulations allow (but do not require) the integration of a hedge with a fixed rate debt instrument. For example, a taxpayer may integrate a fixed rate debt instrument and a swap into a VRDI. Although the hedging transaction regulations (§ 1.446-4) cover many of these transactions, the integration rules provide more certain treatment. The final regulations, however, do not allow the Commissioner to integrate a hedge with either a fixed rate debt instrument or a VRDI that provides for interest at a qualified floating rate. In these cases, treating the hedge and the debt instrument separately is a longstanding rule that generally clearly reflects income.

Second, in limited circumstances, the final regulations allow a hedge to be entered into prior to the date the taxpayer issues or acquires the debt instrument. In these circumstances, however, the taxpayer must identify the

hedge as part of an integrated transaction on the day the hedge is entered into by the taxpayer. Under the final regulations, if the hedging transaction has not yet had any cash flows (including amounts paid to enter into or purchase the hedge), the integration rules work appropriately so that any built-in gain or loss on the hedge at the time of integration is included over the term of the synthetic debt instrument. Thus, the final regulations put no restriction on the time the hedging transaction has to be entered into in this case. If there have been cash flows on the hedge, the final regulations require the hedge to be entered into no earlier than a date that is substantially contemporaneous with the date on which the debt instrument is acquired. This approach should allow commercially reasonable transactions to be integrated without the need to create complex rules to determine the treatment of prior cash flows on the hedging transaction.

The rules for remote and incidental contingencies in § 1.1275-2(h) apply for purposes of the integration rules. Thus, if there is an incidental mismatch between a § 1.1275-6 hedge and a qualifying debt instrument, a taxpayer may still integrate the hedge and the instrument. The mismatch is dealt with according to the rules for incidental contingencies.

The final regulations also clarify the timing of income, deductions, gains, and losses from a hedge of a contingent payment debt instrument not subject to integration. Under § 1.446-4, the income, deductions, gains, and losses must match the income, deductions, gains, and losses from the debt instrument. The final regulations clarify that gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to § 1.1275-4(c) is taken into account when the contingent payment is taken into account under § 1.1275-4(c). This treatment does not allow the taxpayer to change the timing of the income, deductions, gains, and losses from the debt instrument.

Effective Dates

In general, the final regulations apply to debt instruments issued on or after August 13, 1996. Section 1.1275-6 applies to a qualifying debt instrument issued on or after August 13, 1996. Section 1.1275-6 also applies to a qualifying debt instrument acquired by the taxpayer on or after August 13, 1996, if the qualifying debt instrument is a fixed rate debt instrument or a VRDI or if the qualifying debt instrument and the § 1.1275-6 hedge are acquired by the

taxpayer substantially contemporaneously. Except as otherwise provided in the regulations, the changes to § 1.1275-5 apply to debt instruments issued on or after April 4, 1994.

Debt Instruments Issued Before the Effective Date of the Final Regulations

For a contingent payment debt instrument issued before August 13, 1996, a taxpayer may use any reasonable method to account for the debt instrument, including a method that would have been required under the proposed regulations when the debt instrument was issued. However, unless § 1.1275-6 applies to the debt instrument, integration is not a reasonable method to account for the instrument.

Consent To Change Accounting Method

The Commissioner grants consent for a taxpayer to change its method of accounting to follow the final regulations in this document. This consent is granted, however, only for a change for the first taxable year in which the taxpayer must account for a debt instrument under the final regulations. The change is made on a cut-off basis (i.e., the new method only applies to debt instruments issued on or after August 13, 1996. Therefore, no items of income or deduction are omitted or duplicated, and no adjustment under section 481 is allowed.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury Department, including Andrew C. Kittler, formerly of the Office of the Assistant Chief Counsel (Financial Institutions and Products), participated in developing these regulations.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for § 1.1275-2T and adding two entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.483-4 also issued under 26 U.S.C. 483(f). * * *
Section 1.1275-6 also issued under 26 U.S.C. 1275(d). * * *

Par. 2. Section 1.163-7 is amended by adding a sentence at the end of paragraph (a) to read as follows:

§ 1.163-7 Deduction for OID on certain debt instruments.

(a) * * * To determine the amount of interest (OID) that is deductible each year on a debt instrument that provides for contingent payments, see § 1.1275-4.
* * * * *

Par. 3. Section 1.446-4 is amended by:

1. Redesignating paragraphs (a)(2)(ii) and (a)(2)(iii) as paragraphs (a)(2)(iii) and (a)(2)(iv), respectively.
2. Adding a new paragraph (a)(2)(ii).
3. Adding a sentence at the end of paragraph (e)(4).

The additions read as follows:

§ 1.446-4 Hedging transactions.

(a) * * *
(2) * * *
(ii) An integrated transaction subject to § 1.1275-6;
* * * * *
(e) * * *
(4) * * * Similarly, gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to § 1.1275-4(c) (a contingent payment debt instrument issued for nonpublicly traded property) is taken into account when the contingent payment is taken into account under § 1.1275-4(c).
* * * * *

§ 1.483-2T [Removed]

Par. 4. Section 1.483-2T is removed effective June 14, 1996.

Par. 5. Section 1.483-4 is added to read as follows:

§ 1.483-4 Contingent payments.

(a) *In general.* This section applies to a contract for the sale or exchange of property (the overall contract) if the contract provides for one or more contingent payments and the contract is subject to section 483. This section applies even if the contract provides for adequate stated interest under § 1.483-2. If this section applies to a contract, interest under the contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to § 1.1275-4(c). Consequently, all noncontingent payments under the overall contract are treated as if made under a separate contract, and interest accruals on this separate contract are computed under rules similar to those contained in § 1.1275-4(c)(3). Each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in § 1.1275-4(c)(4). However, any interest, or amount treated as interest, on a contract subject to this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method).

(b) *Examples.* The following examples illustrate the provisions of paragraph (a) of this section:

Example 1. Deferred payment sale with contingent interest—(i) Facts. On December 31, 1996, A sells depreciable personal property to B. As consideration for the sale, B issues to A a debt instrument with a maturity date of December 31, 2001. The debt instrument provides for a principal payment of \$200,000 on the maturity date, and a payment of interest on December 31 of each year, beginning in 1997, equal to a percentage of the total gross income derived from the property in that year. However, the total interest payable on the debt instrument over its entire term is limited to a maximum of \$50,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually, and the mid-term applicable Federal rate is 5 percent, compounded annually.

(ii) *Treatment of noncontingent payment as separate contract.* Each payment of interest is a contingent payment. Accordingly, under paragraph (a) of this section, for purposes of applying section 483 to the debt instrument, the right to the noncontingent payment of \$200,000 is treated as a separate contract. The amount of unstated interest on this separate contract is equal to \$43,295, which is the amount by which the payment (\$200,000) exceeds the present value of the payment (\$156,705), calculated using the test rate of 5 percent, compounded annually. The \$200,000 payment is thus treated as consisting of a

payment of interest of \$43,295 and a payment of principal of \$156,705. The interest is includible in A's gross income, and deductible by B, under their respective methods of accounting.

(iii) *Treatment of contingent payments.* Assume that the amount of the contingent payment that is paid on December 31, 1997, is \$20,000. Under paragraph (a) of this section, the \$20,000 payment is treated as a payment of principal of \$19,231 (the present value, as of the date of sale, of the \$20,000 payment, calculated using a test rate equal to 4 percent, compounded annually) and a payment of interest of \$769. The \$769 interest payment is includible in A's gross income, and deductible by B, in their respective taxable years in which the payment occurs. The amount treated as principal gives B additional basis in the property on December 31, 1997. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 4 percent, compounded annually, for the payments made on December 31, 1998, and December 31, 1999, and a test rate of 5 percent, compounded annually, for the payments made on December 31, 2000, and December 31, 2001.

Example 2. Contingent stock payout—(i) Facts. M Corporation and N Corporation each owns one-half of the stock of O Corporation. On December 31, 1996, pursuant to a reorganization qualifying under section 368(a)(1)(B), M acquires the one-half interest of O held by N in exchange for 30,000 shares of M voting stock and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1997 or in 1998. In 1999, the annual earnings of O exceed the specified amount, and, on December 31, 1999, an additional 3,000 M voting shares are transferred to N. The fair market value of the 3,000 shares on December 31, 1999, is \$300,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually. M and N are calendar year taxpayers.

(ii) *Allocation of interest.* Section 1274 does not apply to the right to receive the additional shares because the right is not a debt instrument for federal income tax purposes. As a result, the transfer of the 3,000 M voting shares to N is a deferred payment subject to section 483 and a portion of the shares is treated as unstated interest under that section. The amount of interest allocable to the shares is equal to the excess of \$300,000 (the fair market value of the shares on December 31, 1999) over \$266,699 (the present value of \$300,000, determined by discounting the payment at the test rate of 4 percent, compounded annually, from December 31, 1999, to December 31, 1996). As a result, the amount of interest allocable to the payment of the shares is \$33,301 (\$300,000-\$266,699). Both M and N take the interest into account in 1999.

(c) *Effective date.* This section applies to sales and exchanges that occur on or after August 13, 1996.

Par. 6. Section 1.1001-1 is amended by revising paragraph (g) to read as follows:

§ 1.1001-1 Computation of gain or loss.

* * * * *

(g) *Debt instruments issued in exchange for property—(1) In general.* If a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273-2 or § 1.1274-2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the amount realized attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain debt instruments that provide for contingent payments—(i) In general.* Paragraph (g)(1) of this section does not apply to a debt instrument subject to either § 1.483-4 or § 1.1275-4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(ii) *Special rule to determine amount realized.* If a debt instrument subject to § 1.1275-4(c) is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1274-2(g), increased by the fair market value of the contingent payments payable on the debt instrument. If a debt instrument subject to § 1.483-4 is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is its stated principal amount, reduced by any unstated interest (as determined under section 483), and increased by the fair market value of the contingent payments payable on the debt instrument. This paragraph (g)(2)(ii), however, does not apply to a debt instrument if the fair market value of the contingent payments is not reasonably ascertainable. Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable.

(3) *Coordination with section 453.* If a debt instrument is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, this paragraph (g) applies rather than § 15a.453-1(d)(2) to determine the

taxpayer's amount realized attributable to the debt instrument.

(4) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

Par. 7. Section 1.1012-1 is amended by revising paragraph (g) to read as follows:

§ 1.1012-1 Basis of property.

* * * * *

(g) *Debt instruments issued in exchange for property—(1) In general.* For purposes of paragraph (a) of this section, if a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273-2 or § 1.1274-2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the cost of the property attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain tax-exempt obligations.* This paragraph (g)(2) applies to a tax-exempt obligation (as defined in section 1275(a)(3)) that is issued in exchange for property and that has an issue price determined under § 1.1274-2(j) (concerning tax-exempt contingent payment obligations and certain tax-exempt variable rate debt instruments subject to section 1274).

Notwithstanding paragraph (g)(1) of this section, if this paragraph (g)(2) applies to a tax-exempt obligation, for purposes of paragraph (a) of this section, the cost of the property that is attributable to the obligation is the sum of the present values of the noncontingent payments (as determined under § 1.1274-2(c)).

(3) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

Par. 8. Section 1.1271-0(b) is amended by:

1. Revising the entries for paragraphs (c)(2), (c)(3), (c)(4), and (d) of § 1.1272-1.
2. Adding an entry for paragraph (c)(7) of § 1.1272-1.
3. Revising the entry for paragraph (g) and adding entries for paragraphs (i) and (j) of § 1.1274-2.
4. Revising the entry for paragraph (g) and adding entries for paragraphs (g), (h), (i), and (j) of § 1.1275-2.
5. Removing the entries for § 1.1275-2T.
6. Adding entries for § 1.1275-4.
7. Adding entries for paragraphs (a)(5) and (a)(6) of § 1.1275-5.
8. Revising the entries for paragraphs (c)(1) and (c)(5) of § 1.1275-5.

9. Adding entries for § 1.1275-6.
The revisions and additions read as follows:

§ 1.1271-0 Original issue discount; effective date; table of contents.

* * * * *

(b) * * *
* * * * *

§ 1.1272-1 Current Inclusion of OID in Income

* * * * *

(c) * * *
(2) Payment schedule that is significantly more likely than not to occur.

(3) Mandatory sinking fund provision.
(4) Consistency rule. [Reserved]

* * * * *

(7) Effective date.
(d) Certain debt instruments that provide for a fixed yield.

* * * * *

§ 1.1274-2 Issue Price of Debt Instruments to Which Section 1274 Applies

* * * * *

(g) Treatment of contingent payment debt instrument.

* * * * *

(i) [Reserved]
(j) Special rules for tax-exempt obligations.
(1) Certain variable rate debt instruments.
(2) Contingent payment debt instruments.
(3) Effective date.

* * * * *

§ 1.1275-2 Special Rules Relating to Debt Instruments

* * * * *

(g) Anti-abuse rule.
(1) In general.
(2) Unreasonable result.
(3) Examples.
(4) Effective date.
(h) Remote and incidental contingencies.
(1) In general.
(2) Remote contingencies.
(3) Incidental contingencies.
(4) Aggregation rule.
(5) Consistency rule.
(6) Subsequent adjustments.
(7) Effective date.
(i) [Reserved]
(j) Treatment of certain modifications.

* * * * *

§ 1.1275-4 Contingent Payment Debt Instruments

(a) Applicability.
(1) In general.
(2) Exceptions.
(3) Insolvency and default.
(4) Convertible debt instruments.
(5) Remote and incidental contingencies.
(b) Noncontingent bond method.
(1) Applicability.
(2) In general.
(3) Description of method.
(4) Comparable yield and projected payment schedule.
(5) Qualified stated interest.
(6) Adjustments.
(7) Adjusted issue price, adjusted basis, and retirement.

(8) Character on sale, exchange, or retirement.
(9) Operating rules.
(c) Method for debt instruments not subject to the noncontingent bond method.

(1) Applicability.
(2) Separation into components.
(3) Treatment of noncontingent payments.
(4) Treatment of contingent payments.
(5) Basis different from adjusted issue price.

(6) Treatment of a holder on sale, exchange, or retirement.

(7) Examples.
(d) Rules for tax-exempt obligations.

(1) In general.
(2) Certain tax-exempt obligations with interest-based or revenue-based payments
(3) All other tax-exempt obligations.
(4) Basis different from adjusted issue price.

(e) Amounts treated as interest under this section.

(f) Effective date.

§ 1.1275-5 Variable Rate Debt Instruments

(a) * * *

(5) No contingent principal payments.
(6) Special rule for debt instruments issued for nonpublicly traded property.

* * * * *

(c) * * *

(1) Definition.

* * * * *

(5) Tax-exempt obligations.

* * * * *

§ 1.1275-6 Integration of Qualifying Debt Instruments

(a) In general.
(b) Definitions.

(1) Qualifying debt instrument.
(2) Section 1.1275-6 hedge.
(3) Financial instrument.
(4) Synthetic debt instrument.

(c) Integrated transaction.
(1) Integration by taxpayer.
(2) Integration by Commissioner.
(d) Special rules for legging into and legging out of an integrated transaction.

(1) Legging into.
(2) Legging out.
(e) Identification requirements.
(f) Taxation of integrated transactions.

(1) General rule.
(2) Issue date.
(3) Term.
(4) Issue price.
(5) Adjusted issue price.
(6) Qualified stated interest.
(7) Stated redemption price at maturity.
(8) Source of interest income and allocation of expense.

(9) Effectively connected income.
(10) Not a short-term obligation.
(11) Special rules in the event of integration by the Commissioner.
(12) Retention of separate transaction rules for certain purposes.

(13) Coordination with consolidated return rules.

(g) Predecessors and successors.

(h) Examples.

(i) [Reserved]

(j) Effective date.

Par. 9. Section 1.1272-1 is amended by:

1. Revising paragraphs (b)(2)(ii), (c), and (d).

2. Adding a sentence at the end of paragraph (f)(2).

3. Removing the language "determining yield and maturity" from the first sentence of paragraph (j) *Example 5* (iii) and adding the language "sections 1272 and 1273" in its place.

4. Removing the language "determining yield and maturity" from the second sentence of paragraph (j) *Example 7* (v) and adding the language "sections 1272 and 1273" in its place.

The revisions and addition read as follows:

§ 1.1272-1 Current inclusion of OID in income.

* * * * *

(b) * * *

(2) * * *

(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

* * * * *

(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.

* * * * *

(f) * * *
 (2) * * * 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).

* * * * *

Par. 10. Section 1.1273-1 is amended by:

1. Removing the language "principal payments uncertain as to time" in the fourth sentence of paragraph (a) and adding the language "a fixed yield" in its place.
2. Revising paragraph (c)(1)(ii).
3. Revising paragraph (f) *Example 4*. The revisions read as follows:

§ 1.1273-1 Definition of OID.

* * * * *

(c) * * * (1) * * *
 (ii) *Unconditionally payable.* Interest is unconditionally payable only if reasonable legal remedies exist to compel timely payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment a remote contingency (within the meaning of § 1.1275-2(h)). For purposes of the preceding sentence, remedies or other

terms and conditions are not taken into account if the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions. For purposes of determining whether interest is unconditionally payable, the possibility of nonpayment due to default, insolvency, or similar circumstances, or due to the exercise of a conversion option described in § 1.1272-1(e) is ignored. This paragraph (c)(1)(ii) applies to debt instruments issued on or after August 13, 1996.

* * * * *

(f) * * *

Example 4. Qualified stated interest on a debt instrument that is subject to an option—

(i) *Facts.* On January 1, 1997, A issues, for \$100,000, a 10-year debt instrument that provides for a \$100,000 principal payment at maturity and for annual interest payments of \$10,000. Under the terms of the debt instrument, A has the option, exercisable on January 1, 2002, to lower the annual interest payments to \$8,000. In addition, the debt instrument gives the holder an unconditional right to put the debt instrument back to A, exercisable on January 1, 2002, in return for \$100,000.

(ii) *Amount of qualified stated interest.* Under paragraph (c)(2) of this section, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. If the payment schedule determined by assuming that the issuer's option will be exercised and the put option will not be exercised were treated as the debt instrument's sole payment schedule, only \$8,000 of each annual interest payment would be qualified stated interest. Under any other payment schedule, the debt instrument would provide for annual qualified stated interest payments of \$10,000. Accordingly, only \$8,000 of each annual interest payment is qualified stated interest. Any excess of each annual interest payment over \$8,000 is included in the debt instrument's stated redemption price at maturity.

* * * * *

Par. 11. Section 1.1274-2 is amended by:

1. Removing the language "§ 1.1272-1(c)(3)(ii)" from paragraph (e) and adding the language "§ 1.1272-1(c)(3)" in its place.
 2. Revising paragraph (g).
 3. Adding and reserving paragraph (i) and adding paragraph (j).
- The revisions and additions read as follows:

§ 1.1274-2 Issue price of debt instruments to which section 1274 applies.

* * * * *

(g) *Treatment of contingent payment debt instruments.* Notwithstanding paragraph (b) of this section, if a debt instrument subject to section 1274 provides for one or more contingent

payments, the issue price of the debt instrument is the lesser of the instrument's noncontingent principal payments and the sum of the present values of the noncontingent payments (as determined under paragraph (c) of this section). However, if the debt instrument is issued in a potentially abusive situation, the issue price of the debt instrument is the fair market value of the noncontingent payments. For additional rules relating to a debt instrument that provides for one or more contingent payments, see § 1.1275-4. This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

* * * * *

(i) [Reserved]

(j) *Special rules for tax-exempt obligations*—(1) *Certain variable rate debt instruments.* Notwithstanding paragraph (b) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is a variable rate debt instrument (within the meaning of § 1.1275-5) that pays interest at an objective rate and is subject to section 1274, the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(2) *Contingent payment debt instruments.* Notwithstanding paragraphs (b) and (g) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is subject to section 1274 and § 1.1275-4, the issue price of the obligation is the fair market value of the obligation. However, in the case of a tax-exempt obligation that is subject to § 1.1275-4(d)(2) (an obligation that provides for interest-based or revenue-based payments), the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

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

Par. 12. Section 1.1275-2 is amended by adding the text of paragraph (g), and adding paragraph (h), adding and reserving paragraph (i), and adding paragraph (j) to read as follows:

§ 1.1275-2 Special rules relating to debt instruments.

* * * * *

(g) *Anti-abuse rule*—(1) *In general.* If a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable

result. For example, if this paragraph (g) applies to a debt instrument that provides for a contingent payment, the Commissioner can treat the contingency as if it were a separate position.

(2) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. In the case of a contingent payment debt instrument, another significant fact is whether the result is obtainable without the application of § 1.1275-4 and any related provisions (e.g., if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (g):

Example 1. A issues a current-pay, increasing-rate note that provides for an early call option. Although the option is deemed exercised on the call date under § 1.1272-1(c)(5), the option is not expected to be exercised by A. In addition, a principal purpose of including the option in the terms of the note is to limit the amount of interest income includible by the holder in the period prior to the call date by virtue of the option rules in § 1.1272-1(c)(5). Moreover, the application of the option rules is expected to substantially reduce the present value of the holder's tax liability. Based on these facts, the application of § 1.1272-1(c)(5) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the regulations (in whole or in part) to the note without regard to § 1.1272-1(c)(5).

Example 2. C, a foreign corporation not subject to U.S. taxation, issues to a U.S. holder a debt instrument that provides for a contingent payment. The debt instrument is issued for cash and is subject to the noncontingent bond method in § 1.1275-4(b). Six months after issuance, C and the holder modify the debt instrument so that there is a deemed reissuance of the instrument under section 1001. The new debt instrument is subject to the rules of § 1.1275-4(c) rather than § 1.1275-4(b). The application of § 1.1275-4(c) is expected to substantially reduce the present value of the holder's tax liability as compared to the application of § 1.1275-4(b). In addition, a principal purpose of the modification is to substantially reduce the present value of the holder's tax liability through the application of § 1.1275-4(c). Based on these facts, the application of § 1.1275-4(c) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the noncontingent bond method to the modified debt instrument.

Example 3. D issues a convertible debt instrument rather than an economically equivalent investment unit consisting of a debt instrument and a warrant. The convertible debt instrument is issued at par and provides for annual payments of interest. D issues the convertible debt instrument rather than the investment unit so that the debt instrument would not have OID. See § 1.1273-2(j). In general, this is a reasonable result in light of the purposes of the applicable statutes. Therefore, the Commissioner generally will not use the authority under this paragraph (g) to depart from the application of § 1.1273-2(j) in this case.

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

(h) *Remote and incidental contingencies*—(1) *In general.* This paragraph (h) applies to a debt instrument if one or more payments on the instrument are subject to either a remote or incidental contingency. Whether a contingency is remote or incidental is determined as of the issue date of the debt instrument, including any date there is a deemed reissuance of the debt instrument under paragraph (h)(6) (ii) or (j) of this section or § 1.1272-1(c)(6). Except as otherwise provided, the treatment of the contingency under this paragraph (h) applies for all purposes of sections 163(e) (other than sections 163(e)(5)) and 1271 through 1275 and the regulations thereunder. For purposes of this paragraph (h), the possibility of impairment of a payment by insolvency, default, or similar circumstances is not a contingency.

(2) *Remote contingencies.* A contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur.

(3) *Incidental contingencies*—(i) *Contingency relating to amount.* A contingency relating to the amount of a payment is incidental if, under all reasonably expected market conditions, the potential amount of the payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(i), the payment is ignored until the payment is made. However, see paragraph (h)(6)(i)(B) of this section for the treatment of the debt instrument if a change in circumstances

occurs prior to the date the payment is made.

(ii) *Contingency relating to time.* A contingency relating to the timing of a payment is incidental if, under all reasonably expected market conditions, the potential difference in the timing of the payment (from the earliest date to the latest date) is insignificant. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(ii), the payment is treated as made on the earliest date that the payment could be made pursuant to the contingency. If the payment is not made on this date, a taxpayer makes appropriate adjustments to take into account the delay in payment. However, see paragraph (h)(6)(i)(C) of this section for the treatment of the debt instrument if the delay is not insignificant.

(4) *Aggregation rule.* For purposes of paragraph (h)(2) of this section, if a debt instrument provides for multiple contingencies each of which has a remote likelihood of occurring but, when all of the contingencies are considered together, there is a greater than remote likelihood that at least one of the contingencies will occur, none of the contingencies is treated as a remote contingency. For purposes of paragraph (h)(3)(i) of this section, if a debt instrument provides for multiple contingencies each of which is incidental but the potential total amount of all of the payments subject to the contingencies is not, under reasonably expected market conditions, insignificant relative to the total expected amount of the remaining payments on the debt instrument, none of the contingencies is treated as incidental.

(5) *Consistency rule.* For purposes of paragraphs (h)(2) and (3) of this section, the issuer's determination that a contingency is either remote or incidental is binding on all holders. However, the issuer's determination is not binding on a holder that explicitly discloses that its determination is different from the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See § 1.1275-2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(6) *Subsequent adjustments—(i) Applicability.* This paragraph (h)(6) applies to a debt instrument when there is a change in circumstances. For

purposes of the preceding sentence, there is a change in circumstances if—

(A) A remote contingency actually occurs or does not occur, contrary to the assumption made in paragraph (h)(2) of this section;

(B) A payment subject to an incidental contingency described in paragraph (h)(3)(i) of this section becomes fixed in an amount that is not insignificant relative to the total expected amount of the remaining payments on the debt instrument; or

(C) A payment subject to an incidental contingency described in paragraph (h)(3)(ii) of this section becomes fixed such that the difference between the assumed payment date and the due date of the payment is not insignificant.

(ii) *In general.* If a change in circumstances occurs, 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 the instrument's adjusted issue price on that date.

(iii) *Contingent payment debt instruments.* Notwithstanding paragraph (h)(6)(ii) of this section, in the case of a contingent payment debt instrument subject to § 1.1275-4, if a change in circumstances occurs, no retirement or reissuance is treated as occurring, but any payment that is fixed as a result of the change in circumstances is governed by the rules in § 1.1275-4 that apply when the amount of a contingent payment becomes fixed.

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

(i) [Reserved]

(j) *Treatment of certain modifications.* If the terms of a debt instrument are modified to defer one or more payments, and the modification does not cause an exchange under section 1001, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date. This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

§ 1.1275-2T [Removed]

Par. 13. Section 1.1275-2T is removed effective August 13, 1996.

Par. 14. In § 1.1275-3, paragraph (b)(1)(i) is revised to read as follows:

§ 1.1275-3 OID information reporting requirements.

* * * * *

(b) * * * (1) * * *

(i) Set forth on the face of the debt instrument the issue price, the amount

of OID, the issue date, the yield to maturity, and, in the case of a debt instrument subject to the rules of § 1.1275-4(b), the comparable yield and projected payment schedule; or

* * * * *

Par. 15. Section 1.1275-4 is added to read as follows:

§ 1.1275-4 Contingent payment debt instruments.

(a) *Applicability—(1) In general.* Except as provided in paragraph (a)(2) of this section, this section applies to any debt instrument that provides for one or more contingent payments. In general, paragraph (b) of this section applies to a contingent payment debt instrument that is issued for money or publicly traded property and paragraph (c) of this section applies to a contingent payment debt instrument that is issued for nonpublicly traded property. Paragraph (d) of this section provides special rules for tax-exempt obligations. See § 1.1275-6 for a taxpayer's treatment of a contingent payment debt instrument and a hedge.

(2) *Exceptions.* This section does not apply to—

(i) A debt instrument that has an issue price determined under section 1273(b)(4) (e.g., a debt instrument subject to section 483);

(ii) A variable rate debt instrument (as defined in § 1.1275-5);

(iii) A debt instrument subject to § 1.1272-1(c) (a debt instrument that provides for certain contingencies) or § 1.1272-1(d) (a debt instrument that provides for a fixed yield);

(iv) A debt instrument subject to section 988 (except as provided in section 988 and the regulations thereunder);

(v) 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);

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

(vii) A debt instrument issued pursuant to a plan or arrangement if—

(A) The plan or arrangement is created by a state statute;

(B) A primary objective of the plan or arrangement is to enable the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and

(C) Contingent payments on the debt instrument are related to such objective.

(3) *Insolvency and default.* A payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

(4) *Convertible debt instruments.* A debt instrument does not provide for contingent payments merely because it provides for an option to convert the 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.

(5) *Remote and incidental contingencies.* A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. See § 1.1275-2(h) for the treatment of remote and incidental contingencies.

(b) *Noncontingent bond method—(1) Applicability.* The noncontingent bond method described in this paragraph (b) applies to a contingent payment debt instrument that has an issue price determined under § 1.1273-2 (e.g., a contingent payment debt instrument that is issued for money or publicly traded property).

(2) *In general.* Under the noncontingent bond method, interest on a debt instrument must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of interest that is taken into account for each accrual period is determined by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument. If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference.

(3) *Description of method.* The following steps describe how to compute the amount of income, deductions, gain, and loss under the noncontingent bond method:

(i) *Step one: Determine the comparable yield.* Determine the comparable yield for the debt instrument under the rules of paragraph (b)(4) of this section. The comparable yield is determined as of the debt instrument's issue date.

(ii) *Step two: Determine the projected payment schedule.* Determine the projected payment schedule for the debt instrument under the rules of paragraph (b)(4) of this section. The projected payment schedule is determined as of the issue date and remains fixed throughout the term of the debt instrument (except under paragraph (b)(9)(ii) of this section, which applies

to a payment that is fixed more than 6 months before it is due).

(iii) *Step three: Determine the daily portions of interest.* Determine the daily portions of interest on the debt instrument for a taxable year as follows. The amount of interest that accrues in each accrual period is the product of the comparable yield of the debt instrument (properly adjusted for the length of the accrual period) and the debt instrument's adjusted issue price at the beginning of the accrual period. See paragraph (b)(7)(ii) of this section to determine the adjusted issue price of the debt instrument. The daily portions of interest are determined by allocating to each day in the accrual period the ratable portion of the interest that accrues in the accrual period. Except as modified by paragraph (b)(3)(iv) of this section, the daily portions of interest are includible in income by a holder for each day in the holder's taxable year on which the holder held the debt instrument and are deductible by the issuer for each day during the issuer's taxable year on which the issuer was primarily liable on the debt instrument.

(iv) *Step four: Adjust the amount of income or deductions for differences between projected and actual contingent payments.* Make appropriate adjustments to the amount of income or deductions attributable to the debt instrument in a taxable year for any differences between projected and actual contingent payments. See paragraph (b)(6) of this section to determine the amount of an adjustment and the treatment of the adjustment.

(4) *Comparable yield and projected payment schedule.* This paragraph (b)(4) provides rules for determining the comparable yield and projected payment schedule for a debt instrument. The comparable yield and projected payment schedule must be supported by contemporaneous documentation showing that both are reasonable, are based on reliable, complete, and accurate data, and are made in good faith.

(i) *Comparable yield—(A) In general.* Except as provided in paragraph (b)(4)(i)(B) of this section, the comparable yield for a debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions. For example, if a § 1.1275-6 hedge (or the substantial equivalent) is available, the comparable yield is the yield on the synthetic fixed rate debt

instrument that would result if the issuer entered into the § 1.1275-6 hedge. If a § 1.1275-6 hedge (or the substantial equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. The comparable yield must be a reasonable yield for the issuer and must not be less than the applicable Federal rate (based on the overall maturity of the debt instrument).

(B) *Presumption for certain debt instruments.* This paragraph (b)(4)(i)(B) applies to a debt instrument if the instrument provides for one or more contingent payments not based on market information and the instrument is part of an issue that is marketed or sold in substantial part to persons for whom the inclusion of interest under this paragraph (b) is not expected to have a substantial effect on their U.S. tax liability. If this paragraph (b)(4)(i)(B) applies to a debt instrument, the instrument's comparable yield is presumed to be the applicable Federal rate (based on the overall maturity of the debt instrument). A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield (determined using the principles in paragraph (b)(4)(i)(A) of this section) that is higher than the applicable Federal rate. The presumption may not be overcome with appraisals or other valuations of nonpublicly traded property. Evidence used to overcome the presumption must be specific to the issuer and must not be based on comparable issuers or general market conditions.

(ii) *Projected payment schedule.* The projected payment schedule for a debt instrument includes each noncontingent payment and an amount for each contingent payment determined as follows:

(A) *Market-based payments.* If a contingent payment is based on market information (a market-based payment), the amount of the projected payment is the forward price of the contingent payment. The forward price of a contingent payment is the amount one party would agree, as of the issue date, to pay an unrelated party for the right to the contingent payment on the settlement date (e.g., the date the contingent payment is made). For example, if the right to a contingent

payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable Federal rate from the issue date to the date the contingent payment is due.

(B) *Other payments.* If a contingent payment is not based on market information (a non-market-based payment), the amount of the projected payment is the expected value of the contingent payment as of the issue date.

(C) *Adjustments to the projected payment schedule.* The projected payment schedule must produce the comparable yield. If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted consistent with the principles of this paragraph (b)(4) to produce the comparable yield. For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for the market-based payments.

(iii) *Market information.* For purposes of this paragraph (b), market information is any information on which an objective rate can be based under § 1.1275-5(c)(1) or (2).

(iv) *Issuer/holder consistency.* The issuer's projected payment schedule is used to determine the holder's interest accruals and adjustments. The issuer must provide the projected payment schedule to the holder in a manner consistent with the issuer disclosure rules of § 1.1275-2(e). If the issuer does not create a projected payment schedule for a debt instrument or the issuer's projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and projected payment schedule for the debt instrument under the rules of this paragraph (b)(4). A holder that determines its own projected payment schedule must explicitly disclose this fact and the reason why the holder set its own schedule (e.g., why the issuer's projected payment schedule is unreasonable). Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

(v) *Issuer's determination respected—*
(A) *In general.* If the issuer maintains

the contemporaneous documentation required by this paragraph (b)(4), the issuer's determination of the comparable yield and projected payment schedule will be respected unless either is unreasonable.

(B) *Unreasonable determination.* For purposes of paragraph (b)(4)(v)(A) of this section, a comparable yield or projected payment schedule generally will be considered unreasonable if it is set with a purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. In a determination of whether a comparable yield or projected payment schedule is unreasonable, consideration will be given to whether the treatment of the debt instrument under this section is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. For example, if a taxable issuer markets a debt instrument to a holder not subject to U.S. taxation, the comparable yield will be given close scrutiny and will not be respected unless contemporaneous documentation shows that the yield is not too high.

(C) *Exception.* Paragraph (b)(4)(v)(A) of this section does not apply to a debt instrument subject to paragraph (b)(4)(i)(B) of this section (concerning a yield presumption for certain debt instruments that provide for non-market-based payments).

(vi) *Examples.* The following examples illustrate the provisions of this paragraph (b)(4). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Market-based payment—(i) *Facts.* On December 31, 1996, X corporation issues for \$1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest, beginning in 1997, at the rate of 6 percent and for a payment at maturity equal to \$1,000,000 plus the excess, if any, of the price of 10,000 shares of publicly traded stock in an unrelated corporation on the maturity date over \$350,000, or less the excess, if any, of \$350,000 over the price of 10,000 shares of the stock on the maturity date. On the issue date, the forward price to purchase 10,000 shares of the stock on December 31, 2006, is \$350,000.

(ii) *Comparable yield.* Under paragraph (b)(4)(i) of this section, the debt instrument's comparable yield is the yield on the synthetic debt instrument that would result if X corporation entered into a § 1.1275-6 hedge. A § 1.1275-6 hedge in this case is a forward contract to purchase 10,000 shares of the stock on December 31, 2006. If X corporation entered into this hedge, the resulting synthetic debt instrument would yield 6 percent, compounded annually. Thus, the

comparable yield on the debt instrument is 6 percent, compounded annually.

(iii) *Projected payment schedule.* Under paragraph (b)(4)(ii) of this section, the projected payment schedule for the debt instrument consists of 10 annual payments of \$60,000 and a projected amount for the contingent payment at maturity. Because the right to the contingent payment is based on market information, the projected amount of the contingent payment is the forward price of the payment. The right to the contingent payment is substantially similar to a right to a payment of \$1,000,000 combined with a cash-settled forward contract for the purchase of 10,000 shares of the stock for \$350,000 on December 31, 2006. Because the forward price to purchase 10,000 shares of the stock on December 31, 2006, is \$350,000, the amount to be received or paid under the forward contract is projected to be zero. As a result, the projected amount of the contingent payment at maturity is \$1,000,000, consisting of the \$1,000,000 base amount and no additional amount to be received or paid under the forward contract.

(A) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is \$370,000. If X corporation entered into a § 1.1275-6 hedge (a forward contract to purchase the shares for \$370,000), the resulting synthetic debt instrument would yield 6.15 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6.15 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of \$60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is \$1,020,000, consisting of the \$1,000,000 base amount plus the excess \$20,000 of the forward price of the stock over the purchase price of the stock under the forward contract.

(B) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is \$330,000. If X corporation entered into a § 1.1275-6 hedge, the resulting synthetic debt instrument would yield 5.85 percent, compounded annually. Thus, the comparable yield on the debt instrument is 5.85 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of \$60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is \$980,000, consisting of the \$1,000,000 base amount minus the excess \$20,000 of the purchase price of the stock under the forward contract over the forward price of the stock.

Example 2. Non-market-based payments—
(i) *Facts.* On December 31, 1996, Y issues to Z for \$1,000,000 a debt instrument that matures on December 31, 2000. The debt instrument has a stated principal amount of \$1,000,000, payable at maturity, and provides for payments on December 31 of each year, beginning in 1997, of \$20,000 plus 1 percent of Y's gross receipts, if any, for the year. On the issue date, Y has outstanding fixed rate debt instruments with maturities of 2 to 10 years that trade at a price that reflects an average of 100 basis points over Treasury

bonds. These debt instruments have terms and conditions similar to those of the debt instrument. Assume that on December 31, 1996, 4-year Treasury bonds have a yield of 6.5 percent, compounded annually, and that no § 1.1275-6 hedge is available for the debt instrument. In addition, assume that the interest inclusions attributable to the debt instrument are expected to have a substantial effect on Z's U.S. tax liability.

(ii) *Comparable yield.* The comparable yield for the debt instrument is equal to the value of the benchmark rate (i.e., the yield on 4-year Treasury bonds) on the issue date plus the spread. Thus, the debt instrument's comparable yield is 7.5 percent, compounded annually.

(iii) *Projected payment schedule.* Y anticipates that it will have no gross receipts in 1997, but that it will have gross receipts in later years, and those gross receipts will grow each year for the next three years. Based on its business projections, Y believes that it is not unreasonable to expect that its gross receipts in 1999 and each year thereafter will grow by between 6 percent and 13 percent over the prior year. Thus, Y must take these expectations into account in establishing a projected payment schedule for the debt instrument that results in a yield of 7.5 percent, compounded annually. Accordingly, Y could reasonably set the following projected payment schedule for the debt instrument:

Date	Noncontingent payment	Contingent payment
12/31/1997	\$20,000	0
12/31/1998	20,000	70,000
12/31/1999	20,000	75,600
12/31/2000	1,020,000	83,850

(5) *Qualified stated interest.* No amounts payable on a debt instrument to which this paragraph (b) applies are qualified stated interest within the meaning of § 1.1273-1(c).

(6) *Adjustments.* This paragraph (b)(6) provides rules for the treatment of positive and negative adjustments under the noncontingent bond method. A taxpayer takes into account only those adjustments that occur during a taxable year while the debt instrument is held by the taxpayer or while the taxpayer is primarily liable on the debt instrument.

(i) *Determination of positive and negative adjustments.* If the amount of a contingent payment is more than the projected amount of the contingent payment, the difference is a positive adjustment on the date of the payment. If the amount of a contingent payment is less than the projected amount of the contingent payment, the difference is a negative adjustment on the date of the payment (or on the scheduled date of the payment if the amount of the payment is zero).

(ii) *Treatment of net positive adjustments.* The amount, if any, by

which total positive adjustments on a debt instrument in a taxable year exceed the total negative adjustments on the debt instrument in the taxable year is a net positive adjustment. A net positive adjustment is treated as additional interest for the taxable year.

(iii) *Treatment of net negative adjustments.* The amount, if any, by which total negative adjustments on a debt instrument in a taxable year exceed the total positive adjustments on the debt instrument in the taxable year is a net negative adjustment. A taxpayer's net negative adjustment on a debt instrument for a taxable year is treated as follows:

(A) *Reduction of interest accruals.* A net negative adjustment first reduces interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section.

(B) *Ordinary income or loss.* If the net negative adjustment exceeds the interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section, the excess is treated as ordinary loss by a holder and ordinary income by an issuer. However, the amount treated as ordinary loss by a holder is limited to the amount by which the holder's total interest inclusions on the debt instrument exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years. The amount treated as ordinary income by an issuer is limited to the amount by which the issuer's total interest deductions on the debt instrument exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years.

(C) *Carryforward.* If the net negative adjustment exceeds the sum of the amounts treated by the taxpayer as a reduction of interest and as ordinary income or loss (as the case may be) on the debt instrument for the taxable year, the excess is a negative adjustment carryforward for the taxable year. In general, a taxpayer treats a negative adjustment carryforward for a taxable year as a negative adjustment on the debt instrument on the first day of the succeeding taxable year. However, if a holder of a debt instrument has a negative adjustment carryforward on the debt instrument in a taxable year in which the debt instrument is sold, exchanged, or retired, the negative adjustment carryforward reduces the holder's amount realized on the sale, exchange, or retirement. If an issuer of a debt instrument has a negative adjustment carryforward on the debt

instrument for a taxable year in which the debt instrument is retired, the issuer takes the negative adjustment carryforward into account as ordinary income.

(D) *Treatment under section 67.* A net negative adjustment is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions).

(iv) *Cross-references.* If a holder has a basis in a debt instrument that is different from the debt instrument's adjusted issue price, the holder may have additional positive or negative adjustments under paragraph (b)(9)(i) of this section. If the amount of a contingent payment is fixed more than 6 months before the date it is due, the amount and timing of the adjustment are determined under paragraph (b)(9)(ii) of this section.

(7) *Adjusted issue price, adjusted basis, and retirement—(i) In general.* If a debt instrument is subject to the noncontingent bond method, this paragraph (b)(7) provides rules to determine the adjusted issue price of the debt instrument, the holder's basis in the debt instrument, and the treatment of any scheduled or unscheduled retirements. In general, because any difference between the actual amount of a contingent payment and the projected amount of the payment is taken into account as an adjustment to income or deduction, the projected payments are treated as the actual payments for purposes of making adjustments to issue price and basis and determining the amount of any contingent payment made on a scheduled retirement.

(ii) *Definition of adjusted issue price.* The adjusted issue price of a debt instrument is equal to the debt instrument's issue price, increased by the interest previously accrued on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument. See paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iii) *Adjustments to basis.* A holder's basis in a debt instrument is increased by the interest previously accrued by the holder on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the

projected amount of any contingent payment previously made on the debt instrument to the holder. See paragraph (b)(9)(i) of this section for special rules that apply when basis is different from adjusted issue price and paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iv) *Scheduled retirements.* For purposes of determining the amount realized by a holder and the repurchase price paid by the issuer on the scheduled retirement of a debt instrument, a holder is treated as receiving, and the issuer is treated as paying, the projected amount of any contingent payment due at maturity. If the amount paid or received is different from the projected amount, see paragraph (b)(6) of this section for the treatment of the difference by the taxpayer. Under paragraph (b)(6)(iii)(C) of this section, the amount realized by a holder on the retirement of a debt instrument is reduced by any negative adjustment carryforward determined in the taxable year of the retirement.

(v) *Unscheduled retirements.* An unscheduled retirement of a debt instrument (or the receipt of a pro-rata prepayment that is treated as a retirement of a portion of a debt instrument under § 1.1275-2(f)) is treated as a repurchase of the debt instrument (or a pro-rata portion of the debt instrument) by the issuer from the holder for the amount paid by the issuer to the holder.

(vi) *Examples.* The following examples illustrate the provisions of paragraphs (b) (6) and (7) of this section. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Treatment of positive and negative adjustments—(i) Facts. On December 31, 1996, Z, a calendar year taxpayer, purchases a debt instrument subject to this paragraph (b) at original issue for \$1,000. The debt instrument's comparable yield is 10 percent, compounded annually, and the projected payment schedule provides for payments of \$500 on December 31, 1997 (consisting of a noncontingent payment of \$375 and a projected amount of \$125) and \$660 on December 31, 1998 (consisting of a noncontingent payment of \$600 and a projected amount of \$60). The debt instrument is a capital asset in the hands of Z.

(ii) *Adjustment in 1997.* Based on the projected payment schedule, Z's total daily portions of interest on the debt instrument are \$100 for 1997 (issue price of \$1,000 x 10

percent). Assume that the payment actually made on December 31, 1997, is \$375, rather than the projected \$500. Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of \$125 on December 31, 1997, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z has no positive adjustments for 1997, Z has a net negative adjustment of \$125 on the debt instrument for 1997. This net negative adjustment reduces to zero the \$100 total daily portions of interest Z would otherwise include in income in 1997. Accordingly, Z has no interest income on the debt instrument for 1997. Because Z had no interest inclusions on the debt instrument for prior taxable years, the remaining \$25 of the net negative adjustment is a negative adjustment carryforward for 1997 that results in a negative adjustment of \$25 on January 1, 1998.

(iii) *Adjustment to issue price and basis.* Z's total daily portions of interest on the debt instrument are \$100 for 1997. The adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are increased by this amount, despite the fact that Z does not include this amount in income because of the net negative adjustment for 1997. In addition, the adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are decreased on December 31, 1997, by the projected amount of the payment on that date (\$500). Thus, on January 1, 1998, Z's adjusted basis in the debt instrument and the adjusted issue price of the debt instrument are \$600.

(iv) *Adjustments in 1998.* Based on the projected payment schedule, Z's total daily portions of interest are \$60 for 1998 (adjusted issue price of \$600 x 10 percent). Assume that the payment actually made on December 31, 1998, is \$700, rather than the projected \$660. Under paragraph (b)(6)(i) of this section, Z has a positive adjustment of \$40 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z also has a negative adjustment of \$25 on January 1, 1998, Z has a net positive adjustment of \$15 on the debt instrument for 1998 (the excess of the \$40 positive adjustment over the \$25 negative adjustment). As a result, Z has \$75 of interest income on the debt instrument for 1998 (the \$15 net positive adjustment plus the \$60 total daily portions of interest that are taken into account by Z in that year).

(v) *Retirement.* Based on the projected payment schedule, Z's adjusted basis in the debt instrument immediately before the payment at maturity is \$660 (\$600 plus \$60 total daily portions of interest for 1998). Even though Z receives \$700 at maturity, for purposes of determining the amount realized by Z on retirement of the debt instrument, Z is treated as receiving the projected amount of the contingent payment on December 31, 1998. Therefore, Z is treated as receiving \$660 on December 31, 1998. Because Z's adjusted basis in the debt instrument immediately before its retirement is \$660, Z recognizes no gain or loss on the retirement.

Example 2. Negative adjustment carryforward for year of sale—(i) Facts.

Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that Z sells the debt instrument on January 1, 1998, for \$630.

(ii) *Gain on sale.* On the date the debt instrument is sold, Z's adjusted basis in the debt instrument is \$600. Because Z has a negative adjustment of \$25 on the debt instrument on January 1, 1998, and has no positive adjustments on the debt instrument in 1998, Z has a net negative adjustment for 1998 of \$25. Because Z has not included in income any interest on the debt instrument, the entire \$25 net negative adjustment is a negative adjustment carryforward for the taxable year of the sale. Under paragraph (b)(6)(iii)(C) of this section, the \$25 negative adjustment carryforward reduces the amount realized by Z on the sale of the debt instrument from \$630 to \$605. Thus, Z has a gain on the sale of \$5 (\$605 - \$600). Under paragraph (b)(8)(i) of this section, the gain is treated as interest income.

Example 3. Negative adjustment carryforward for year of retirement—(i) Facts. Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that the payment actually made on December 31, 1998, is \$615, rather than the projected \$660.

(ii) *Adjustments in 1998.* Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of \$45 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. In addition, Z has a negative adjustment of \$25 on January 1, 1998. See *Example 1*(ii) of this paragraph (b)(7)(vi). Because Z has no positive adjustments in 1998, Z has a net negative adjustment of \$70 for 1998. This net negative adjustment reduces to zero the \$60 total daily portions of interest Z would otherwise include in income for 1998. Therefore, Z has no interest income on the debt instrument for 1998. Because Z had no interest inclusions on the debt instrument for 1997, the remaining \$10 of the net negative adjustment is a negative adjustment carryforward for 1998 that reduces the amount realized by Z on retirement of the debt instrument.

(iii) *Loss on retirement.* Immediately before the payment at maturity, Z's adjusted basis in the debt instrument is \$660. Under paragraph (b)(7)(iv) of this section, Z is treated as receiving the projected amount of the contingent payment, or \$660, as the payment at maturity. Under paragraph (b)(6)(iii)(C) of this section, however, this amount is reduced by any negative adjustment carryforward determined for the taxable year of retirement to calculate the amount Z realizes on retirement of the debt instrument. Thus, Z has a loss of \$10 on the retirement of the debt instrument, equal to the amount by which Z's adjusted basis in the debt instrument (\$660) exceeds the amount Z realizes on the retirement of the debt instrument (\$660 minus the \$10 negative adjustment carryforward). Under paragraph (b)(8)(ii) of this section, the loss is a capital loss.

(8) *Character on sale, exchange, or retirement—(i) Gain.* Any gain recognized by a holder on the sale,

exchange, or retirement of a debt instrument subject to this paragraph (b) is interest income.

(ii) *Loss.* Any loss recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is ordinary loss to the extent that the holder's total interest inclusions on the debt instrument exceed the total net negative adjustments on the debt instrument the holder took into account as ordinary loss. Any additional loss is treated as loss from the sale, exchange, or retirement of the debt instrument. However, any loss that would otherwise be ordinary under this paragraph (b)(8)(ii) and that is attributable to the holder's basis that could not be amortized under section 171(b)(4) is loss from the sale, exchange, or retirement of the debt instrument.

(iii) *Special rule if there are no remaining contingent payments on the debt instrument—(A) In general.* Notwithstanding paragraphs (b)(8)(i) and (ii) of this section, if, at the time of the sale, exchange, or retirement of the debt instrument, there are no remaining contingent payments due on the debt instrument under the projected payment schedule, any gain or loss recognized by the holder is gain or loss from the sale, exchange, or retirement of the debt instrument. See paragraph (b)(9)(ii) of this section to determine whether there are no remaining contingent payments on a debt instrument that provides for fixed but deferred contingent payments.

(B) *Exception for certain positive adjustments.* Notwithstanding paragraph (b)(8)(iii)(A) of this section, if a positive adjustment on a debt instrument is spread under paragraph (b)(9)(ii)(F) or (G) of this section, any gain recognized by the holder on the sale, exchange, or retirement of the instrument is treated as interest income to the extent of the positive adjustment that has not yet been accrued and included in income by the holder.

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (b)(8). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Gain on sale—(i) Facts. On January 1, 1998, D, a calendar year taxpayer, sells a debt instrument that is subject to paragraph (b) of this section for \$1,350. The projected payment schedule for the debt instrument provides for contingent payments after January 1, 1998. On January 1, 1998, D has an adjusted basis in the debt instrument of \$1,200. In addition, D has a negative

adjustment carryforward of \$50 for 1997 that, under paragraph (b)(6)(iii)(C) of this section, results in a negative adjustment of \$50 on January 1, 1998. D has no positive adjustments on the debt instrument on January 1, 1998.

(ii) *Character of gain.* Under paragraph (b)(6) of this section, the \$50 negative adjustment on January 1, 1998, results in a negative adjustment carryforward for 1998, the taxable year of the sale of the debt instrument. Under paragraph (b)(6)(iii)(C) of this section, the negative adjustment carryforward reduces the amount realized by D on the sale of the debt instrument from \$1,350 to \$1,300. As a result, D realizes a \$100 gain on the sale of the debt instrument, equal to the \$1,300 amount realized minus D's \$1,200 adjusted basis in the debt instrument. Under paragraph (b)(8)(i) of this section, the gain is interest income to D.

Example 2. Loss on sale—(i) Facts. On December 31, 1996, E, a calendar year taxpayer, purchases a debt instrument at original issue for \$1,000. The debt instrument is a capital asset in the hands of E. The debt instrument provides for a single payment on December 31, 1998 (the maturity date of the instrument), of \$1,000 plus an amount based on the increase, if any, in the price of a specified commodity over the term of the instrument. The comparable yield for the debt instrument is 9.54 percent, compounded annually, and the projected payment schedule provides for a payment of \$1,200 on December 31, 1998. Based on the projected payment schedule, the total daily portions of interest are \$95 for 1997 and \$105 for 1998.

(ii) *Ordinary loss.* Assume that E sells the debt instrument for \$1,050 on December 31, 1997. On that date, E has an adjusted basis in the debt instrument of \$1,095 (\$1,000 original basis, plus total daily portions of \$95 for 1997). Therefore, E realizes a \$45 loss on the sale of the debt instrument (\$1,050 - \$1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument (\$95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, the \$45 loss is an ordinary loss.

(iii) *Capital loss.* Alternatively, assume that E sells the debt instrument for \$990 on December 31, 1997. E realizes a \$105 loss on the sale of the debt instrument (\$990 - \$1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument (\$95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, \$95 of the \$105 loss is an ordinary loss. The remaining \$10 of the \$105 loss is a capital loss.

(9) *Operating rules.* The rules of this paragraph (b)(9) apply to a debt instrument subject to the noncontingent bond method notwithstanding any other rule of this paragraph (b).

(i) *Basis different from adjusted issue price.* This paragraph (b)(9)(i) provides rules for a holder whose basis in a debt instrument is different from the adjusted

issue price of the debt instrument (e.g., a subsequent holder that purchases the debt instrument for more or less than the instrument's adjusted issue price).

(A) *General rule.* The holder accrues interest under paragraph (b)(3)(iii) of this section and makes adjustments under paragraph (b)(3)(iv) of this section based on the projected payment schedule determined as of the issue date of the debt instrument. However, upon acquiring the debt instrument, the holder must reasonably allocate any difference between the adjusted issue price and the basis to daily portions of interest or projected payments over the remaining term of the debt instrument. Allocations are taken into account under paragraphs (b)(9)(i)(B) and (C) of this section.

(B) *Basis greater than adjusted issue price.* If the holder's basis in the debt instrument exceeds the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a negative adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is reduced by the amount the holder treats as a negative adjustment under this paragraph (b)(9)(i)(B). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(C) *Basis less than adjusted issue price.* If the holder's basis in the debt instrument is less than the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a positive adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is increased by the amount the holder treats as a positive adjustment under this paragraph (b)(9)(i)(C). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(D) *Premium and discount rules do not apply.* The rules for accruing premium and discount in sections 171, 1272(a)(7), 1276, and 1281 do not apply. Other rules of those sections, such as section 171(b)(4), continue to apply to the extent relevant.

(E) *Safe harbor for exchange listed debt instruments.* If the debt instrument is exchange listed property (within the meaning of § 1.1273-2(f)(2)), it is reasonable for the holder to allocate any difference between the holder's basis

and the adjusted issue price of the debt instrument pro-rata to daily portions of interest (as determined under paragraph (b)(3)(iii) of this section) over the remaining term of the debt instrument. A pro-rata allocation is not reasonable, however, to the extent the holder's yield on the debt instrument, determined after taking into account the amounts allocated under this paragraph (b)(9)(i)(E), is less than the applicable Federal rate for the instrument. For purposes of the preceding sentence, the applicable Federal rate for the debt instrument is determined as if the purchase date were the issue date and the remaining term of the instrument were the term of the instrument.

(F) *Examples.* The following examples illustrate the provisions of this paragraph (b)(9)(i). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. In addition, assume that each instrument is not exchange listed property.

Example 1. Basis greater than adjusted issue price—(i) Facts. On July 1, 1998, Z purchases for \$1,405 a debt instrument that matures on December 31, 1999, and promises to pay on the maturity date \$1,000 plus the increase, if any, in the price of a specified amount of a commodity from the issue date to the maturity date. The debt instrument was originally issued on December 31, 1996, for an issue price of \$1,000. The comparable yield for the debt instrument is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for a single payment at maturity of \$1,350. At the time of the purchase, the debt instrument has an adjusted issue price of \$1,162, assuming semiannual accrual periods ending on December 31 and June 30 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment and not to a decrease in market interest rates. The debt instrument is a capital asset in the hands of Z. Z is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Z's basis in the debt instrument on July 1, 1998, is \$1,405. Under paragraph (b)(9)(i)(A) of this section, Z allocates the \$243 difference between basis (\$1,405) and adjusted issue price (\$1,162) to the contingent payment at maturity. Z's allocation of the difference between basis and adjusted issue price is reasonable because the increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment.

(iii) *Treatment of debt instrument for 1998.* Based on the projected payment schedule, \$60 of interest accrues on the debt instrument from July 1, 1998 to December 31, 1998 (the product of the debt instrument's

adjusted issue price on July 1, 1998 (\$1,162) and the comparable yield properly adjusted for the length of the accrual period (10.25 percent/2)). Z has no net negative or positive adjustments for 1998. Thus, Z includes in income \$60 of total daily portions of interest for 1998. On December 31, 1998, Z's adjusted basis in the debt instrument is \$1,465 (\$1,405 original basis, plus total daily portions of \$60 for 1998).

(iv) *Effect of allocation to contingent payment at maturity.* Assume that the payment actually made on December 31, 1999, is \$1,400, rather than the projected \$1,350. Thus, under paragraph (b)(6)(i) of this section, Z has a positive adjustment of \$50 on December 31, 1999. In addition, under paragraph (b)(9)(i)(B) of this section, Z has a negative adjustment of \$243 on December 31, 1999, which is attributable to the difference between Z's basis in the debt instrument on July 1, 1998, and the instrument's adjusted issue price on that date. As a result, Z has a net negative adjustment of \$193 for 1999. This net negative adjustment reduces to zero the \$128 total daily portions of interest Z would otherwise include in income in 1999. Accordingly, Z has no interest income on the debt instrument for 1999. Because Z had \$60 of interest inclusions for 1998, \$60 of the remaining \$65 net negative adjustment is treated by Z as an ordinary loss for 1999. The remaining \$5 of the net negative adjustment is a negative adjustment carryforward for 1999 that reduces the amount realized by Z on the retirement of the debt instrument from \$1,350 to \$1,345.

(v) *Loss at maturity.* On December 31, 1999, Z's basis in the debt instrument is \$1,350 (\$1,405 original basis, plus total daily portions of \$60 for 1998 and \$128 for 1999, minus the negative adjustment of \$243). As a result, Z realizes a loss of \$5 on the retirement of the debt instrument (the difference between the amount realized on the retirement (\$1,345) and Z's adjusted basis in the debt instrument (\$1,350)). Under paragraph (b)(8)(ii) of this section, the \$5 loss is treated as loss from the retirement of the debt instrument. Consequently, Z realizes a total loss of \$65 on the debt instrument for 1999 (a \$60 ordinary loss and a \$5 capital loss).

Example 2. Basis less than adjusted issue price—(i) Facts. On January 1, 1999, Y purchases for \$910 a debt instrument that pays 7 percent interest semiannually on June 30 and December 31 of each year, and that promises to pay on December 31, 2001, \$1,000 plus or minus \$10 times the positive or negative difference, if any, between a specified amount and the value of an index on December 31, 2001. However, the payment on December 31, 2001, may not be less than \$650. The debt instrument was originally issued on December 31, 1996, for an issue price of \$1,000. The comparable yield for the debt instrument is 9.80 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for semiannual payments of \$35 and a contingent payment at maturity of \$1,175. On January 1, 1999, the debt instrument has an adjusted issue price of \$1,060, assuming semiannual accrual periods ending on

December 31 and June 30 of each year. Y is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price.* Y's basis in the debt instrument on January 1, 1999, is \$910. Under paragraph (b)(9)(i)(A) of this section, Y must allocate the \$150 difference between basis (\$910) and adjusted issue price (\$1,060) to daily portions of interest or to projected payments. These amounts will be positive adjustments taken into account at the time the daily portions accrue or the payments are made.

(A) Assume that, because of a decrease in the relevant index, the expected value of the payment at maturity has declined by about 9 percent. Based on forward prices on January 1, 1999, Y determines that approximately \$105 of the difference between basis and adjusted issue price is allocable to the contingent payment. Y allocates the remaining \$45 to daily portions of interest on a pro-rata basis (i.e., the amount allocated to an accrual period equals the product of \$45 and a fraction, the numerator of which is the total daily portions for the accrual period and the denominator of which is the total daily portions remaining on the debt instrument on January 1, 1999). This allocation is reasonable.

(B) Assume alternatively that, based on yields of comparable debt instruments and its purchase price for the debt instrument, Y determines that an appropriate yield for the debt instrument is 13 percent, compounded semiannually. Based on this determination, Y allocates \$55.75 of the difference between basis and adjusted issue price to daily portions of interest as follows: \$15.19 to the daily portions of interest for the taxable year ending December 31, 1999; \$18.40 to the daily portions of interest for the taxable year ending December 31, 2000; and \$22.16 to the daily portions of interest for the taxable year ending December 31, 2001. Y allocates the remaining \$94.25 to the contingent payment at maturity. This allocation is reasonable.

(ii) *Fixed but deferred contingent payments.* This paragraph (b)(9)(ii) provides rules that apply when the amount of a contingent payment becomes fixed before the payment is due. For purposes of paragraph (b) of this section, if a contingent payment becomes fixed within the 6-month period ending on the due date of the payment, the payment is treated as a contingent payment even after the payment is fixed. If a contingent payment becomes fixed more than 6 months before the payment is due, the following rules apply to the debt instrument.

(A) *Determining adjustments.* The amount of the adjustment attributable to the contingent payment is equal to the difference between the present value of the amount that is fixed and the present value of the projected amount of the contingent payment. The present value of each amount is determined by discounting the amount from the date the payment is due to the date the

payment becomes fixed, using a discount rate equal to the comparable yield on the debt instrument. The adjustment is treated as a positive or negative adjustment, as appropriate, on the date the contingent payment becomes fixed. See paragraph (b)(9)(ii)(G) of this section to determine the timing of the adjustment if all remaining contingent payments on the debt instrument become fixed substantially contemporaneously.

(B) *Payment schedule.* The contingent payment is no longer treated as a contingent payment after the date the amount of the payment becomes fixed. On the date the contingent payment becomes fixed, the projected payment schedule for the debt instrument is modified prospectively to reflect the fixed amount of the payment. Therefore, no adjustment is made under paragraph (b)(3)(iv) of this section when the contingent payment is actually made.

(C) *Accrual period.* Notwithstanding the determination under § 1.1272-1(b)(1)(ii) of accrual periods for the debt instrument, an accrual period ends on the day the contingent payment becomes fixed, and a new accrual period begins on the day after the day the contingent payment becomes fixed.

(D) *Adjustments to basis and adjusted issue price.* The amount of any positive adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section increases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument. Similarly, the amount of any negative adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section decreases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument.

(E) *Basis different from adjusted issue price.* If a holder's basis in a debt instrument exceeds the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a negative adjustment on the date the payment becomes fixed. If a holder's basis in a debt instrument is less than the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a positive adjustment on the date the payment becomes fixed.

(F) *Special rule for certain contingent interest payments.* Notwithstanding paragraph (b)(9)(ii)(A) of this section, this paragraph (b)(9)(ii)(F) applies to contingent stated interest payments that are adjusted to compensate for contingencies regarding the

reasonableness of the debt instrument's stated rate of interest. For example, this paragraph (b)(9)(ii)(F) applies to a debt instrument that provides for an increase in the stated rate of interest if the credit quality of the issuer or liquidity of the debt instrument deteriorates. Contingent stated interest payments of this type are recognized over the period to which they relate in a reasonable manner.

(G) *Special rule when all contingent payments become fixed.*

Notwithstanding paragraph (b)(9)(ii)(A) of this section, if all the remaining contingent payments on a debt instrument become fixed substantially contemporaneously, any positive or negative adjustments on the instrument are taken into account in a reasonable manner over the period to which they relate. For purposes of the preceding sentence, a payment is treated as a fixed payment if all remaining contingencies with respect to the payment are remote or incidental (within the meaning of § 1.1275-2(h)).

(H) *Example.* The following example illustrates the provisions of this paragraph (b)(9)(ii). In this example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example. Fixed but deferred payments—(i) Facts. On December 31, 1996, B, a calendar year taxpayer, purchases a debt instrument at original issue for \$1,000. The debt instrument matures on December 31, 2002, and provides for a payment of \$1,000 at maturity. In addition, on December 31, 1999, and December 31, 2002, the debt instrument provides for payments equal to the excess of the average daily value of an index for the 6-month period ending on September 30 of the preceding year over a specified amount. The debt instrument's comparable yield is 10 percent, compounded annually, and the instrument's projected payment schedule consists of a payment of \$250 on December 31, 1999, and a payment of \$1,439 on December 31, 2002. B uses annual accrual periods.

(ii) *Interest accrual for 1997.* Based on the projected payment schedule, B includes a total of \$100 of daily portions of interest in income in 1997. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1997, is \$1,100.

(iii) *Interest accrual for 1998—(A) Adjustment.* Based on the projected payment schedule, B would include \$110 of total daily portions of interest in income in 1998. However, assume that on September 30, 1998, the payment due on December 31, 1999, fixes at \$300, rather than the projected \$250. Thus, on September 30, 1998, B has an adjustment equal to the difference between the present value of the \$300 fixed amount and the present value of the \$250 projected

amount of the contingent payment. The present values of the two payments are determined by discounting each payment from the date the payment is due (December 31, 1999) to the date the payment becomes fixed (September 30, 1998), using a discount rate equal to 10 percent, compounded annually. The present value of the fixed payment is \$266.30 and the present value of the projected amount of the contingent payment is \$221.91. Thus, on September 30, 1998, B has a positive adjustment of \$44.39 (\$266.30-\$221.91).

(B) *Effect of adjustment.* Under paragraph (b)(9)(ii)(C) of this section, B's accrual period ends on September 30, 1998. The daily portions of interest on the debt instrument for the period from January 1, 1998 to September 30, 1998 total \$81.51. The adjusted issue price of the debt instrument and B's adjusted basis in the debt instrument are thus increased over this period by \$125.90 (the sum of the daily portions of interest of \$81.51 and the positive adjustment of \$44.39 made at the end of the period) to \$1,225.90. For purposes of all future accrual periods, including the new accrual period from October 1, 1998, to December 31, 1998, the debt instrument's projected payment schedule is modified to reflect a fixed payment of \$300 on December 31, 1999. Based on the new adjusted issue price of the debt instrument and the new projected payment schedule, the yield on the debt instrument does not change.

(C) *Interest accrual for 1998.* Based on the modified projected payment schedule, \$29.56 of interest accrues during the accrual period that ends on December 31, 1998. Because B has no other adjustments during 1998, the \$44.39 positive adjustment on September 30, 1998, results in a net positive adjustment for 1998, which is additional interest for that year. Thus, B includes \$155.46 (\$81.51+\$29.56+\$44.39) of interest in income in 1998. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1998, is \$1,255.46 (\$1,225.90 from the end of the prior accrual period plus \$29.56 total daily portions for the current accrual period).

(iii) *Timing contingencies.* This paragraph (b)(9)(iii) provides rules for debt instruments that have payments that are contingent as to time.

(A) *Treatment of certain options.* If a taxpayer has an unconditional option to put or call the debt instrument, to exchange the debt instrument for other property, or to extend the maturity date of the debt instrument, the projected payment schedule is determined by using the principles of § 1.1272-1(c)(5).

(B) *Other timing contingencies.*
[Reserved]

(iv) *Cross-border transactions—(A) Allocation of deductions.* For purposes of § 1.861-8, the holder of a debt instrument shall treat any deduction or loss treated as an ordinary loss under paragraph (b)(6)(iii)(B) or (b)(8)(ii) of this section as a deduction that is definitely related to the class of gross

income to which income from such debt instrument belongs. Accordingly, if a U.S. person holds a debt instrument issued by a related controlled foreign corporation and, pursuant to section 904(d)(3) and the regulations thereunder, any interest accrued by such U.S. person with respect to such debt instrument would be treated as foreign source general limitation income, any deductions relating to a net negative adjustment will reduce the U.S. person's foreign source general limitation income. The holder shall apply the general rules relating to allocation and apportionment of deductions to any other deduction or loss realized by the holder with respect to the debt instrument.

(B) *Investments in United States real property.* Notwithstanding paragraph (b)(8)(i) of this section, gain on the sale, exchange, or retirement of a debt instrument that is a United States real property interest is treated as gain for purposes of sections 897, 1445, and 6039C.

(v) *Coordination with subchapter M and related provisions.* For purposes of sections 852(c)(2) and 4982 and § 1.852-11, any positive adjustment, negative adjustment, income, or loss on a debt instrument that occurs after October 31 of a taxable year is treated in the same manner as foreign currency gain or loss that is attributable to a section 988 transaction.

(vi) *Coordination with section 1092.* A holder treats a negative adjustment and an issuer treats a positive adjustment as a loss with respect to a position in a straddle if the debt instrument is a position in a straddle and the contingency (or any portion of the contingency) to which the adjustment relates would be part of the straddle if entered into as a separate position.

(c) *Method for debt instruments not subject to the noncontingent bond method—(1) Applicability.* This paragraph (c) applies to a contingent payment debt instrument (other than a tax-exempt obligation) that has an issue price determined under § 1.1274-2. For example, this paragraph (c) generally applies to a contingent payment debt instrument that is issued for nonpublicly traded property.

(2) *Separation into components.* If paragraph (c) of this section applies to a debt instrument (the overall debt instrument), the noncontingent payments are subject to the rules in paragraph (c)(3) of this section, and the contingent payments are accounted for separately under the rules in paragraph (c)(4) of this section.

(3) *Treatment of noncontingent payments.* The noncontingent payments

are treated as a separate debt instrument. The issue price of the separate debt instrument is the issue price of the overall debt instrument, determined under § 1.1274-2(g). No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of § 1.1273-1(c)) and the de minimis rules of section 1273(a)(3) and § 1.1273-1(d) do not apply to the separate debt instrument.

(4) *Treatment of contingent payments—(i) In general.* Except as provided in paragraph (c)(4)(iii) of this section, the portion of a contingent payment treated as interest under paragraph (c)(4)(ii) of this section is includible in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the payment is made.

(ii) *Characterization of contingent payments as principal and interest—(A) General rule.* A contingent payment is treated as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date. The amount of the payment in excess of the amount treated as principal under the preceding sentence is treated as a payment of interest.

(B) *Test rate.* The test rate used for purposes of paragraph (c)(4)(ii)(A) of this section is the rate that would be the test rate for the overall debt instrument under § 1.1274-4 if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is made. However, in the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate determined under the preceding sentence, the test rate is the stated interest rate.

(iii) *Certain delayed contingent payments—(A) General rule.* Notwithstanding paragraph (c)(4)(ii) of this section, if a contingent payment becomes fixed more than 6 months before the payment is due, the issuer and holder are treated as if the issuer had issued a separate debt instrument on the date the payment becomes fixed, maturing on the date the payment is due. This separate debt instrument is treated as a debt instrument to which section 1274 applies. The stated principal amount of this separate debt instrument is the amount of the payment that becomes fixed. An amount equal to the issue price of this debt instrument is characterized as interest or principal under the rules of

paragraph (c)(4)(ii) of this section and accounted for as if this amount had been paid by the issuer to the holder on the date that the amount of the payment becomes fixed. To determine the issue price of the separate debt instrument, the payment is discounted at the test rate from the maturity date of the separate debt instrument to the date that the amount of the payment becomes fixed.

(B) *Test rate.* The test rate used for purposes of paragraph (c)(4)(iii)(A) of this section is determined in the same manner as the test rate under paragraph (c)(4)(ii)(B) of this section is determined except that the date the contingent payment is due is used rather than the date the contingent payment is made.

(5) *Basis different from adjusted issue price.* This paragraph (c)(5) provides rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (e.g., a subsequent holder). This paragraph (c)(5), however, does not apply if the holder is reporting income under the installment method of section 453.

(i) *Allocation of basis.* The holder must allocate basis to the noncontingent component (i.e., the right to the noncontingent payments) and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining basis, if any, to the contingent component (i.e., the right to the contingent payments).

(ii) *Noncontingent component.* Any difference between the holder's basis in the noncontingent component and the adjusted issue price of the noncontingent component, and any difference between the holder's basis in a separate debt instrument and the adjusted issue price of the separate debt instrument, is taken into account under the rules for market discount, premium, and acquisition premium that apply to a noncontingent debt instrument.

(iii) *Contingent component.* Amounts received by the holder that are treated as principal payments under paragraph (c)(4)(ii) of this section reduce the holder's basis in the contingent component. If the holder's basis in the contingent component is reduced to zero, any additional principal payments on the contingent component are treated as gain from the sale or exchange of the debt instrument. Any basis remaining on the contingent component on the date the final contingent payment is made increases the holder's adjusted basis in the noncontingent component

(or, if there are no remaining noncontingent payments, is treated as loss from the sale or exchange of the debt instrument).

(6) *Treatment of a holder on sale, exchange, or retirement.* This paragraph (c)(6) provides rules for the treatment of a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (c). Under this paragraph (c)(6), the holder must allocate the amount received from the sale, exchange, or retirement of a debt instrument first to the noncontingent component and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining amount received, if any, to the contingent component.

(i) *Amount allocated to the noncontingent component.* The amount allocated to the noncontingent component and any separate debt instruments is treated as an amount realized from the sale, exchange, or retirement of the noncontingent component or separate debt instrument.

(ii) *Amount allocated to the contingent component.* The amount allocated to the contingent component is treated as a contingent payment that is made on the date of the sale, exchange, or retirement and is characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section.

(7) *Examples.* The following examples illustrate the provisions of this paragraph (c). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Contingent interest payments—

(i) *Facts.* A owns Blackacre, unencumbered depreciable real estate. On January 1, 1997, A sells Blackacre to B. As consideration for the sale, B makes a downpayment of \$1,000,000 and issues to A a debt instrument that matures on December 31, 2001. The debt instrument provides for a payment of principal at maturity of \$5,000,000 and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents B receives from Blackacre in that year. Assume that the debt instrument is not issued in a potentially abusive situation. Assume also that on January 1, 1997, the short-term applicable Federal rate is 5 percent, compounded annually, and the mid-term applicable Federal rate is 6 percent, compounded annually.

(ii) *Determination of issue price.* Under § 1.1274-2(g), the issue price of the debt

instrument is \$3,736,291, which is the present value, as of the issue date, of the \$5,000,000 noncontingent payment due at maturity, calculated using a discount rate equal to the mid-term applicable Federal rate. Under § 1.1012-1(g)(1), B's basis in Blackacre on January 1, 1997, is \$4,736,291 (\$1,000,000 down payment plus the \$3,736,291 issue price of the debt instrument).

(iii) *Noncontingent payment treated as separate debt instrument.* Under paragraph (c)(3) of this section, the right to the noncontingent payment of principal at maturity is treated as a separate debt instrument. The issue price of this separate debt instrument is \$3,736,291 (the issue price of the overall debt instrument). The separate debt instrument has a stated redemption price at maturity of \$5,000,000 and, therefore, OID of \$1,263,709.

(iv) *Treatment of contingent payments.* Assume that the amount of contingent interest that is fixed and paid on December 31, 1997, is \$200,000. Under paragraph (c)(4)(ii) of this section, this payment is treated as consisting of a payment of principal of \$190,476, which is the present value of the payment, determined by discounting the payment at the test rate of 5 percent, compounded annually, from the date the payment is made to the issue date. The remainder of the \$200,000 payment (\$9,524) is treated as interest. The additional amount treated as principal gives B additional basis in Blackacre on December 31, 1997. The portion of the payment treated as interest is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 5 percent, compounded annually, for the contingent payments due on December 31, 1998, and December 31, 1999, and a test rate of 6 percent, compounded annually, for the contingent payments due on December 31, 2000, and December 31, 2001.

Example 2. Fixed but deferred payment—
(i) *Facts.* The facts are the same as in paragraph (c)(7) *Example 1* of this section, except that the contingent payment of interest that is fixed on December 31, 1997, is not payable until December 31, 2001, the maturity date.

(ii) *Treatment of deferred contingent payment.* Assume that the amount of the payment that becomes fixed on December 31, 1997, is \$200,000. Because this amount is not payable until December 31, 2001, under paragraph (c)(4)(iii) of this section, a separate debt instrument to which section 1274 applies is treated as issued by B on December 31, 1997 (the date the payment is fixed). The maturity date of this separate debt instrument is December 31, 2001 (the date on which the payment is due). The stated principal amount of this separate debt instrument is \$200,000, the amount of the payment that becomes fixed. The imputed principal amount of the separate debt instrument is \$158,419, which is the present value, as of December 31, 1997, of the \$200,000 payment, computed using a discount rate equal to the test rate of the overall debt instrument (6 percent, compounded annually). An amount equal to

the issue price of the separate debt instrument is treated as an amount paid on December 31, 1997, and characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section. The amount of the deemed payment characterized as principal is equal to \$150,875, which is the present value, as of January 1, 1997 (the issue date of the overall debt instrument), of the deemed payment, computed using a discount rate of 5 percent, compounded annually. The amount of the deemed payment characterized as interest is \$7,544 (\$158,419 - \$150,875), which is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs.

(d) *Rules for tax-exempt obligations—*
(1) *In general.* Except as modified by this paragraph (d), the noncontingent bond method described in paragraph (b) of this section applies to a tax-exempt obligation (as defined in section 1275(a)(3)) to which this section applies. Paragraph (d)(2) of this section applies to certain tax-exempt obligations that provide for interest-based payments or revenue-based payments and paragraph (d)(3) of this section applies to all other obligations. Paragraph (d)(4) of this section provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation.

(2) *Certain tax-exempt obligations with interest-based or revenue-based payments—*(i) *Applicability.* This paragraph (d)(2) applies to a tax-exempt obligation that provides for interest-based payments or revenue-based payments.

(ii) *Interest-based payments.* A tax-exempt obligation provides for interest-based payments if the obligation would otherwise qualify as a variable rate debt instrument under § 1.1275-5 except that—

(A) The obligation provides for more than one fixed rate;

(B) The obligation provides for one or more caps, floors, or governors (or similar restrictions) that are fixed as of the issue date;

(C) The interest on the obligation is not compounded or paid at least annually; or

(D) The obligation provides for interest at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, or at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, increased or decreased by a fixed rate.

(iii) *Revenue-based payments.* A tax-exempt obligation provides for revenue-based payments if the obligation—

(A) Is issued to refinance (including a series of refinancings) an obligation (in a series of refinancings, the original

obligation), the proceeds of which were used to finance a project or enterprise; and

(B) Would otherwise qualify as a variable rate debt instrument under § 1.1275-5 except that it provides for stated interest payments at least annually based on a single fixed percentage of the revenue, value, change in value, or other similar measure of the performance of the refinanced project or enterprise.

(iv) *Modifications to the noncontingent bond method.* If a tax-exempt obligation is subject to this paragraph (d)(2), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Daily portions and net positive adjustments.* The daily portions of interest determined under paragraph (b)(3)(iii) of this section and any net positive adjustment on the obligation are interest for purposes of section 103.

(B) *Net negative adjustments.* A net negative adjustment for a taxable year reduces the amount of tax-exempt interest the holder would otherwise account for on the obligation for the taxable year under paragraph (b)(3)(iii) of this section. If the net negative adjustment exceeds this amount, the excess is a nondeductible, noncapitalizable loss. If a regulated investment company (RIC) within the meaning of section 851 has a net negative adjustment in a taxable year that would be a nondeductible, noncapitalizable loss under the prior sentence, the RIC must use this loss to reduce its tax-exempt interest income on other tax-exempt obligations held during the taxable year.

(C) *Gains.* Any gain recognized on the sale, exchange, or retirement of the obligation is gain from the sale or exchange of the obligation.

(D) *Losses.* Any loss recognized on the sale, exchange, or retirement of the obligation is treated the same as a net negative adjustment under paragraph (d)(2)(iv)(B) of this section.

(E) *Special rule for losses and net negative adjustments.* Notwithstanding paragraphs (d)(2)(iv)(B) and (D) of this section, on the sale, exchange, or retirement of the obligation, the holder may claim a loss from the sale or exchange of the obligation to the extent the holder has not received in cash or property the sum of its original investment in the obligation and any amounts included in income under paragraph (d)(4)(ii) of this section.

(3) *All other tax-exempt obligations—*
(i) *Applicability.* This paragraph (d)(3) applies to a tax-exempt obligation that

is not subject to paragraph (d)(2) of this section.

(ii) *Modifications to the noncontingent bond method.* If a tax-exempt obligation is subject to this paragraph (d)(3), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Modification to projected payment schedule.* The comparable yield for the obligation is the greater of the obligation's yield, determined without regard to the contingent payments, and the tax-exempt applicable Federal rate that applies to the obligation. The Internal Revenue Service publishes the tax-exempt applicable Federal rate for each month in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter).

(B) *Daily portions.* The daily portions of interest determined under paragraph (b)(3)(iii) of this section are interest for purposes of section 103.

(C) *Adjustments.* A net positive adjustment on the obligation is treated as gain to the holder from the sale or exchange of the obligation in the taxable year of the adjustment. A net negative adjustment on the obligation is treated as a loss to the holder from the sale or exchange of the obligation in the taxable year of the adjustment.

(D) *Gains and losses.* Any gain or loss recognized on the sale, exchange, or retirement of the obligation is gain or loss from the sale or exchange of the obligation.

(4) *Basis different from adjusted issue price.* This paragraph (d)(4) provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation. The rules of paragraph (b)(9)(i) of this section do not apply to tax-exempt obligations.

(i) *Basis greater than adjusted issue price.* If the holder's basis in the obligation exceeds the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is not deductible by the holder. However, the holder's basis in the obligation is reduced by the amount allocated to a daily portion of interest on the date the daily portion accrues.

(ii) *Basis less than adjusted issue price.* If the holder's basis in the obligation is less than the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation.

The amount allocated to a daily portion of interest is includible in income by the holder as ordinary income on the date the daily portion accrues. The holder's adjusted basis in the obligation is increased by the amount includible in income by the holder under this paragraph (d)(4)(ii) on the date the daily portion accrues.

(iii) *Premium and discount rules do not apply.* The rules for accruing premium and discount in sections 171, 1276, and 1288 do not apply. Other rules of those sections continue to apply to the extent relevant.

(e) *Amounts treated as interest under this section.* Amounts treated as interest under this section are treated as OID for all purposes of the Internal Revenue Code.

(f) *Effective date.* This section applies to debt instruments issued on or after August 13, 1996.

Par. 16. Section 1.1275-5 is amended by:

1. Revising paragraph (a)(1).
2. Removing the language "The debt instrument must provide for stated interest" from the introductory language of paragraph (a)(3)(i) and adding the language "The debt instrument must not provide for any stated interest other than stated interest" in its place.
3. Removing the language "less than 1 year" from the first sentence of paragraph (a)(3)(ii) and adding the language "1 year or less" in its place.
4. Adding paragraphs (a)(5) and (a)(6).
5. Revising paragraph (b)(2).
6. Revising paragraphs (c)(1) and (c)(5).
7. Removing the language "cost of newly borrowed funds" from paragraph (c)(3)(ii) and adding the language "qualified floating rate" in its place.
8. Revising paragraph (d) introductory text; revising *Examples 4* through *9*; and adding *Example 10*.
9. Revising paragraph (e)(2).
10. Revising paragraph (e)(3)(v) introductory text; revising *Example 3* (ii); and removing *Example 3* (iii).

The revisions and additions read as follows:

§ 1.1275-5 Variable rate debt instruments.

(a) *Applicability—(1) In general.* This section provides rules for variable rate debt instruments. Except as provided in paragraph (a)(6) of this section, a variable rate debt instrument is a debt instrument that meets the conditions described in paragraphs (a)(2), (3), (4), and (5) of this section. If a debt instrument that provides for a variable rate of interest does not qualify as a variable rate debt instrument, the debt instrument is a contingent payment debt instrument. See § 1.1275-4 for the

treatment of a contingent payment debt instrument. See § 1.1275-6 for a taxpayer's treatment of a variable rate debt instrument and a hedge.

* * * * *

(5) *No contingent principal payments.* Except as provided in paragraph (a)(2) of this section, the debt instrument must not provide for any principal payments that are contingent (within the meaning of § 1.1275-4(a)).

(6) *Special rule for debt instruments issued for nonpublicly traded property.* A debt instrument (other than a tax-exempt obligation) that would otherwise qualify as a variable rate debt instrument under this section is not a variable rate debt instrument if section 1274 applies to the instrument and any stated interest payments on the instrument are treated as contingent payments under § 1.1274-2. This paragraph (a)(6) applies to debt instruments issued on or after August 13, 1996.

(b) * * *

(2) *Certain rates based on a qualified floating rate.* For a debt instrument issued on or after August 13, 1996, a variable rate is a qualified floating rate if it is equal to either—

(i) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35; or

(ii) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35, increased or decreased by a fixed rate.

* * * * *

(c) *Objective rate—(1) Definition—(i) In general.* For debt instruments issued on or after August 13, 1996, an objective rate is a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information. For example, an objective rate generally includes a rate that is based on one or more qualified floating rates or on the yield of actively traded personal property (within the meaning of section 1092(d)(1)).

(ii) *Exception.* For purposes of paragraph (c)(1)(i) of this section, an objective rate does not include a rate based on information that is within the control of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)) or that is unique to the circumstances of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)), such as dividends, profits, or the value of the issuer's stock. However, a rate does not fail to be an

objective rate merely because it is based on the credit quality of the issuer.

* * * * *

(5) *Tax-exempt obligations.* Notwithstanding paragraph (c)(1) of this section, in the case of a tax-exempt obligation (within the meaning of section 1275(a)(3)), a variable rate is an objective rate only if it is a qualified inverse floating rate or a qualified inflation rate. A rate is a qualified inflation rate if the rate measures contemporaneous changes in inflation based on a general inflation index.

(d) *Examples.* The following examples illustrate the rules of paragraphs (b) and (c) of this section. For purposes of these examples, assume that the debt instrument is not a tax-exempt obligation. In addition, unless otherwise provided, assume that the rate is not reasonably expected to result in a significant front-loading or back-loading of interest and that the rate is not based on objective financial or economic information that is within the control of the issuer (or a related party) or that is unique to the circumstances of the issuer (or a related party).

* * * * *

Example 4. Rate based on changes in the value of a commodity index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to the percentage increase, if any, in the value of an index for the year immediately preceding the payment. The index is based on the prices of several actively traded commodities. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 5. Rate based on a percentage of S&P 500 Index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year based on a fixed percentage of the value of the S&P 500 Index. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds and, therefore, the rate is not a qualified floating rate. Although the rate is described in paragraph (c)(1)(i) of this section, the rate is not an objective rate because, based on historical data, it is reasonably expected that the average value of the rate during the first half of the instrument's term will be significantly less than the average value of the rate during the final half of the instrument's term.

Example 6. Rate based on issuer's profits. On January 1, 1997, Z issues a debt instrument that provides for annual interest payments equal to 1 percent of Z's gross profits earned during the year immediately preceding the payment. Variations in the

value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. In addition, because the rate is based on information that is unique to the issuer's circumstances, the rate is not an objective rate.

Example 7. Rate based on a multiple of an interest index. On January 1, 1997, Z issues a debt instrument with annual interest payments at a rate equal to two times the value of 1-year LIBOR as of the payment date. Because the rate is a multiple greater than 1.35 times a qualified floating rate, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 8. Variable rate based on the cost of borrowed funds in a foreign currency. On January 1, 1997, Y issues a 5-year dollar denominated debt instrument that provides for annual interest payments at a rate equal to the value of 1-year French franc LIBOR as of the payment date. Variations in the value of French franc LIBOR do not measure contemporaneous changes in the cost of newly borrowed funds in dollars. As a result, the rate is not a qualified floating rate for an instrument denominated in dollars. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 9. Qualified inverse floating rate. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 12 percent minus the value of 1-year LIBOR as of the payment date. On the issue date, the value of 1-year LIBOR is 6 percent. Because the rate can reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR, it is a qualified inverse floating rate. However, if the value of 1-year LIBOR on the issue date were 11 percent rather than 6 percent, the rate would not be a qualified inverse floating rate because the rate could not reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR.

Example 10. Rate based on an inflation index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 400 basis points (4 percent) plus the annual percentage change in a general inflation index (e.g., the Consumer Price Index, U.S. City Average, All Items, for all Urban Consumers, seasonally unadjusted). The rate, however, may not be less than zero. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective economic information using a single fixed formula, the rate is an objective rate.

(e) * * *

(2) *Variable rate debt instrument that provides for annual payments of interest at a single variable rate.* If a variable rate debt instrument provides for stated interest at a single qualified floating rate

or objective rate and the interest is unconditionally payable in cash or in property (other than debt instruments of the issuer), or will be constructively received under section 451, at least annually, the following rules apply to the instrument:

(i) All stated interest with respect to the debt instrument is qualified stated interest.

(ii) The amount of qualified stated interest and the amount of OID, if any, that accrues during an accrual period is determined under the rules applicable to fixed rate debt instruments by assuming that the variable rate is a fixed rate equal to—

(A) In the case of a qualified floating rate or qualified inverse floating rate, the value, as of the issue date, of the qualified floating rate or qualified inverse floating rate; or

(B) In the case of an objective rate (other than a qualified inverse floating rate), a fixed rate that reflects the yield that is reasonably expected for the debt instrument.

(iii) The qualified stated interest allocable to an accrual period is increased (or decreased) if the interest actually paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period under paragraph (e)(2)(ii) of this section.

(3) * * *

(v) *Examples.* The following examples illustrate the rules in paragraphs (e) (2) and (3) of this section:

* * * * *

Example 3. * * *

(ii) *Accrual of OID and qualified stated interest.* Under paragraph (e)(2) of this section, the variable rate debt instrument is treated as a 2-year debt instrument that has an issue price of \$90,000, a stated principal amount of \$100,000, and interest payments of \$5,000 at the end of each year. The debt instrument has \$10,000 of OID and the annual interest payments of \$5,000 are qualified stated interest payments. Under § 1.1272-1, the debt instrument has a yield of 10.82 percent, compounded annually. The amount of OID allocable to the first annual accrual period (assuming Z uses annual accrual periods) is \$4,743.25 $(\$90,000 \times .1082) - \$5,000$, and the amount of OID allocable to the second annual accrual period is \$5,256.75 $(\$100,000 - \$94,743.25)$. Under paragraph (e)(2)(iii) of this section, the \$2,000 difference between the \$7,000 interest payment actually made at maturity and the \$5,000 interest payment assumed to be made at maturity under the equivalent fixed rate debt instrument is treated as additional qualified stated interest for the period.

* * * * *

Par. 17. Section 1.1275-6 is added to read as follows:

§ 1.1275-6 Integration of qualifying debt instruments.

(a) *In general.* This section generally provides for the integration of a qualifying debt instrument with a hedge or combination of hedges if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. The integrated transaction is generally subject to the rules of this section rather than the rules to which each component of the transaction would be subject on a separate basis. The purpose of this section is to permit a more appropriate determination of the character and timing of income, deductions, gains, or losses than would be permitted by separate treatment of the components. The rules of this section affect only the taxpayer who holds (or issues) the qualifying debt instrument and enters into the hedge.

(b) *Definitions—*(1) *Qualifying debt instrument.* A qualifying debt instrument is any debt instrument (including an integrated transaction as defined in paragraph (c) of this section) other than—

(i) A tax-exempt obligation as defined in section 1275(a)(3);

(ii) 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); or

(iii) A debt instrument that is subject to § 1.483-4 or § 1.1275-4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(2) *Section 1.1275-6 hedge—*(i) *In general.* A § 1.1275-6 hedge is any financial instrument (as defined in paragraph (b)(3) of this section) if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles of section 1272), or the right to the combined cash flows would qualify under § 1.1275-5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument is not a § 1.1275-6 hedge, however, if the resulting synthetic debt instrument does not have the same term as the remaining term of the qualifying debt instrument. A financial instrument that hedges currency risk is not a § 1.1275-6 hedge.

(ii) *Limitations—*(A) A debt instrument issued by a taxpayer and a debt instrument held by the taxpayer cannot be part of the same integrated transaction.

(B) A debt instrument can be a § 1.1275-6 hedge only if it is issued substantially contemporaneously with, and has the same maturity (including rights to accelerate or delay payments) as, the qualifying debt instrument.

(3) *Financial instrument.* For purposes of this section, a financial instrument is a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or combination or series of financial instruments. Stock is not a financial instrument for purposes of this section.

(4) *Synthetic debt instrument.* The synthetic debt instrument is the hypothetical debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and the § 1.1275-6 hedge.

(c) *Integrated transaction—*(1) *Integration by taxpayer.* Except as otherwise provided in this section, a qualifying debt instrument and a § 1.1275-6 hedge are an integrated transaction if all of the following requirements are satisfied:

(i) The taxpayer satisfies the identification requirements of paragraph (e) of this section on or before the date the taxpayer enters into the § 1.1275-6 hedge.

(ii) None of the parties to the § 1.1275-6 hedge are related within the meaning of section 267(b) or 707(b)(1), or, if the parties are related, the party providing the hedge uses, for federal income tax purposes, a mark-to-market method of accounting for the hedge and all similar or related transactions.

(iii) Both the qualifying debt instrument and the § 1.1275-6 hedge are entered into by the same individual, partnership, trust, estate, or corporation (regardless of whether the corporation is a member of an affiliated group of corporations that files a consolidated return).

(iv) If the taxpayer is a foreign person engaged in a U.S. trade or business and the taxpayer issues or acquires a qualifying debt instrument, or enters into a § 1.1275-6 hedge, through the trade or business, all items of income and expense associated with the qualifying debt instrument and the § 1.1275-6 hedge (other than interest expense that is subject to § 1.882-5) would have been effectively connected with the U.S. trade or business throughout the term of the qualifying debt instrument had this section not applied.

(v) Neither the qualifying debt instrument, nor any other debt instrument that is part of the same issue as the qualifying debt instrument, nor the § 1.1275-6 hedge was, with respect

to the taxpayer, part of an integrated transaction that was terminated or otherwise legged out of within the 30 days immediately preceding the date that would be the issue date of the synthetic debt instrument.

(vi) The qualifying debt instrument is issued or acquired by the taxpayer on or before the date of the first payment on the § 1.1275-6 hedge, whether made or received by the taxpayer (including a payment made to purchase the hedge). If the qualifying debt instrument is issued or acquired by the taxpayer after, but substantially contemporaneously with, the date of the first payment on the § 1.1275-6 hedge, the qualifying debt instrument is treated, solely for purposes of this paragraph (c)(1)(vi), as meeting the requirements of the preceding sentence.

(vii) Neither the § 1.1275-6 hedge nor the qualifying debt instrument was, with respect to the taxpayer, part of a straddle (as defined in section 1092(c)) prior to the issue date of the synthetic debt instrument.

(2) *Integration by Commissioner.* The Commissioner may treat a qualifying debt instrument and a financial instrument (whether entered into by the taxpayer or by a related party) as an integrated transaction if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a § 1.1275-6 hedge. The Commissioner, however, may not integrate a transaction unless the qualifying debt instrument either is subject to § 1.1275-4 or is subject to § 1.1275-5 and pays interest at an objective rate. The circumstances under which the Commissioner may require integration include, but are not limited to, the following:

(i) A taxpayer fails to identify a qualifying debt instrument and the § 1.1275-6 hedge under paragraph (e) of this section.

(ii) A taxpayer issues or acquires a qualifying debt instrument and a related party (within the meaning of section 267(b) or 707(b)(1)) enters into the § 1.1275-6 hedge.

(iii) A taxpayer issues or acquires a qualifying debt instrument and enters into the § 1.1275-6 hedge with a related party (within the meaning of section 267(b) or 707(b)(1)).

(iv) The taxpayer legs out of an integrated transaction and within 30 days enters into a new § 1.1275-6 hedge with respect to the same qualifying debt instrument or another debt instrument that is part of the same issue.

(d) *Special rules for legging into and legging out of an integrated*

transaction—(1) Legging into—(i) Definition. Legging into an integrated transaction under this section means that a § 1.1275-6 hedge is entered into after the date the qualifying debt instrument is issued or acquired by the taxpayer, and the requirements of paragraph (c)(1) of this section are satisfied on the date the § 1.1275-6 hedge is entered into (the leg-in date).

(ii) *Treatment.* If a taxpayer legs into an integrated transaction, the taxpayer treats the qualifying debt instrument under the applicable rules for taking interest and OID into account up to the leg-in date, except that the day before the leg-in date is treated as the end of an accrual period. As of the leg-in date, the qualifying debt instrument is subject to the rules of paragraph (f) of this section.

(iii) *Anti-abuse rule.* If a taxpayer legs into an integrated transaction with a principal purpose of deferring or accelerating income or deductions on the qualifying debt instrument, the Commissioner may—

(A) Treat the qualifying debt instrument as sold for its fair market value on the leg-in date; or

(B) Refuse to allow the taxpayer to integrate the qualifying debt instrument and the § 1.1275-6 hedge.

(2) *Legging out—(i) Definition—(A) Legging out if the taxpayer has integrated.* If a taxpayer has integrated a qualifying debt instrument and a § 1.1275-6 hedge under paragraph (c)(1) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the § 1.1275-6 hedge ceases to meet the requirements for a § 1.1275-6 hedge, the taxpayer fails to meet any requirement of paragraph (c)(1) of this section, or the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or § 1.1275-6 hedge. If the taxpayer fails to meet the requirements of paragraph (c)(1) of this section but meets the requirements of paragraph (c)(2) of this section, the Commissioner may treat the taxpayer as not legging out.

(B) *Legging out if the Commissioner has integrated.* If the Commissioner has integrated a qualifying debt instrument and a financial instrument under paragraph (c)(2) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the requirements for Commissioner integration under paragraph (c)(2) of this section are not met or the taxpayer fails to meet the requirements for taxpayer integration under paragraph (c)(1) of this section and the Commissioner agrees to allow the taxpayer to be treated as legging out.

(C) *Exception for certain nonrecognition transactions.* If, in a single nonrecognition transaction, a taxpayer disposes of, or ceases to be primarily liable on, the qualifying debt instrument and the § 1.1275-6 hedge, the taxpayer is not treated as legging out. Instead, the integrated transaction is treated under the rules governing the nonrecognition transaction. For example, if a holder of an integrated transaction is acquired in a reorganization under section 368(a)(1)(A), the holder is treated as disposing of the synthetic debt instrument in the reorganization rather than legging out. If the successor holder is not eligible for integrated treatment, the successor is treated as legging out.

(ii) *Operating rules.* If a taxpayer legs out (or is treated as legging out) of an integrated transaction, the following rules apply:

(A) The transaction is treated as an integrated transaction during the time the requirements of paragraph (c)(1) or (2) of this section, as appropriate, are satisfied.

(B) Immediately before the taxpayer legs out, the taxpayer is treated as selling or otherwise terminating the synthetic debt instrument for its fair market value and, except as provided in paragraph (d)(2)(ii)(D) of this section, any income, deduction, gain, or loss is realized and recognized at that time.

(C) If, immediately after the taxpayer legs out, the taxpayer holds or remains primarily liable on the qualifying debt instrument, adjustments are made to reflect any difference between the fair market value of the qualifying debt instrument and the adjusted issue price of the qualifying debt instrument. If, immediately after the taxpayer legs out, the taxpayer is a party to a § 1.1275-6 hedge, the § 1.1275-6 hedge is treated as entered into at its fair market value.

(D) If a taxpayer legs out of an integrated transaction by disposing of or otherwise terminating a § 1.1275-6 hedge within 30 days of legging into the integrated transaction, then any loss or deduction determined under paragraph (d)(2)(ii)(B) of this section is not allowed. Appropriate adjustments are made to the qualifying debt instrument for any disallowed loss. The adjustments are taken into account on a yield to maturity basis over the remaining term of the qualifying debt instrument.

(E) If a holder of a debt instrument subject to § 1.1275-4 legs into an integrated transaction with respect to the instrument and subsequently legs out of the integrated transaction, any gain recognized under paragraph (d)(2)(ii)(B) or (C) of this section is

treated as interest income to the extent determined under the principles of § 1.1275-4(b)(8)(iii)(B) (rules for determining the character of gain on the sale of a debt instrument all of the payments on which have been fixed). If the synthetic debt instrument would qualify as a variable rate debt instrument, the equivalent fixed rate debt instrument determined under § 1.1275-5(e) is used for this purpose.

(e) *Identification requirements.* For each integrated transaction, a taxpayer must enter and retain as part of its books and records the following information—

(1) The date the qualifying debt instrument was issued or acquired (or is expected to be issued or acquired) by the taxpayer and the date the § 1.1275-6 hedge was entered into by the taxpayer;

(2) A description of the qualifying debt instrument and the § 1.1275-6 hedge; and

(3) A summary of the cash flows and accruals resulting from treating the qualifying debt instrument and the § 1.1275-6 hedge as an integrated transaction (i.e., the cash flows and accruals on the synthetic debt instrument).

(f) *Taxation of integrated transactions—*(1) *General rule.* An integrated transaction is generally treated as a single transaction by the taxpayer during the period that the transaction qualifies as an integrated transaction. Except as provided in paragraph (f)(12) of this section, while a qualifying debt instrument and a § 1.1275-6 hedge are part of an integrated transaction, neither the qualifying debt instrument nor the § 1.1275-6 hedge is subject to the rules that would apply on a separate basis to the debt instrument and the § 1.1275-6 hedge, including section 1092 or § 1.446-4. The rules that would govern the treatment of the synthetic debt instrument generally govern the treatment of the integrated transaction. For example, the integrated transaction may be subject to section 263(g) or, if the synthetic debt instrument would be part of a straddle, section 1092. Generally, the synthetic debt instrument is subject to sections 163(e) and 1271 through 1275, with terms as set forth in paragraphs (f)(2) through (13) of this section.

(2) *Issue date.* The issue date of the synthetic debt instrument is the first date on which the taxpayer entered into all of the components of the synthetic debt instrument.

(3) *Term.* The term of the synthetic debt instrument is the period beginning on the issue date of the synthetic debt

instrument and ending on the maturity date of the qualifying debt instrument.

(4) *Issue price.* The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument on the issue date of the synthetic debt instrument. If, as a result of entering into the § 1.1275-6 hedge, the taxpayer pays or receives one or more payments that are substantially contemporaneous with the issue date of the synthetic debt instrument, the payments reduce or increase the issue price as appropriate.

(5) *Adjusted issue price.* In general, the adjusted issue price of the synthetic debt instrument is determined under the principles of § 1.1275-1(b).

(6) *Qualified stated interest.* No amounts payable on the synthetic debt instrument are qualified stated interest within the meaning of § 1.1273-1(c).

(7) *Stated redemption price at maturity—*(i) *Synthetic debt instruments that are borrowings.* In general, if the synthetic debt instrument is a borrowing, the instrument's stated redemption price at maturity is the sum of all amounts paid or to be paid on the qualifying debt instrument and the § 1.1275-6 hedge, reduced by any amounts received or to be received on the § 1.1275-6 hedge.

(ii) *Synthetic debt instruments that are held by the taxpayer.* In general, if the synthetic debt instrument is held by the taxpayer, the instrument's stated redemption price at maturity is the sum of all amounts received or to be received by the taxpayer on the qualifying debt instrument and the § 1.1275-6 hedge, reduced by any amounts paid or to be paid by the taxpayer on the § 1.1275-6 hedge.

(iii) *Certain amounts ignored.* For purposes of this paragraph (f)(7), if an amount paid or received on the § 1.1275-6 hedge is taken into account under paragraph (f)(4) of this section to determine the issue price of the synthetic debt instrument, the amount is not taken into account to determine the synthetic debt instrument's stated redemption price at maturity.

(8) *Source of interest income and allocation of expense.* The source of interest income from the synthetic debt instrument is determined by reference to the source of income of the qualifying debt instrument under sections 861(a)(1) and 862(a)(1). For purposes of section 904, the character of interest from the synthetic debt instrument is determined by reference to the character of the interest income from the qualifying debt instrument. Interest expense is allocated and apportioned under regulations under section 861 or under § 1.882-5.

(9) *Effectively connected income.* If the requirements of paragraph (c)(1)(iv) of this section are satisfied, any interest income resulting from the synthetic debt instrument entered into by the foreign person is treated as effectively connected with a U.S. trade or business, and any interest expense resulting from the synthetic debt instrument entered into by the foreign person is allocated and apportioned under § 1.882-5.

(10) *Not a short-term obligation.* For purposes of section 1272(a)(2)(C), a synthetic debt instrument is not treated as a short-term obligation.

(11) *Special rules in the event of integration by the Commissioner.* If the Commissioner requires integration, appropriate adjustments are made to the treatment of the synthetic debt instrument, and, if necessary, the qualifying debt instrument and financial instrument. For example, the Commissioner may treat a financial instrument that is not a § 1.1275-6 hedge as a § 1.1275-6 hedge when applying the rules of this section. The issue date of the synthetic debt instrument is the date determined appropriate by the Commissioner to require integration.

(12) *Retention of separate transaction rules for certain purposes.* This paragraph (f)(12) provides for the retention of separate transaction rules for certain purposes. In addition, by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter), the Commissioner may require use of separate transaction rules for any aspect of an integrated transaction.

(i) *Foreign persons that enter into integrated transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business.* If a foreign person enters into an integrated transaction that gives rise to U.S. source interest income (determined under the source rules for the synthetic debt instrument) not effectively connected with a U.S. trade or business of the foreign person, paragraph (f) of this section does not apply for purposes of sections 871(a), 881, 1441, 1442, and 6049. These sections of the Internal Revenue Code are applied to the qualifying debt instrument and the § 1.1275-6 hedge on a separate basis.

(ii) *Relationship between taxpayer and other persons.* Because the rules of this section affect only the taxpayer that enters into an integrated transaction (i.e., either the issuer or a particular holder of a qualifying debt instrument), any provisions of the Internal Revenue Code or regulations that govern the relationship between the taxpayer and any other person are applied on a separate basis. For example, taxpayers

must comply with any reporting or disclosure requirements on any qualifying debt instrument as if it were not part of an integrated transaction. Thus, if required under § 1.1275-4(b)(4), an issuer of a contingent payment debt instrument subject to integrated treatment must provide the projected payment schedule to holders. Similarly, if a U.S. corporation enters into an integrated transaction that includes a notional principal contract, the source of any payment received by the counterparty on the notional principal contract is determined under § 1.863-7 as if the contract were not part of an integrated transaction, and, if received by a foreign person who is not engaged in a U.S. trade or business, the payment is non-U.S. source income that is not subject to U.S. withholding tax.

(13) *Coordination with consolidated return rules.* If a taxpayer enters into a § 1.1275-6 hedge with a member of the same consolidated group (the counterparty) and the § 1.1275-6 hedge is part of an integrated transaction for the taxpayer, the § 1.1275-6 hedge is not treated as an intercompany transaction for purposes of § 1.1502-13. If the taxpayer legs out of integrated treatment, the taxpayer and the counterparty are each treated as disposing of its position in the § 1.1275-6 hedge under the principles of paragraph (d)(2) of this section. If the § 1.1275-6 hedge remains in existence after the leg-out date, the § 1.1275-6 hedge is treated under the rules that would otherwise apply to the transaction (including § 1.1502-13 if the transaction is between members).

(g) *Predecessors and successors.* For purposes of this section, any reference to a taxpayer, holder, issuer, or person includes, where appropriate, a reference to a predecessor or successor. For purposes of the preceding sentence, a predecessor is a transferor of an asset or liability (including an integrated transaction) to a transferee (the successor) in a nonrecognition transaction. Appropriate adjustments, if necessary, are made in the application of this section to predecessors and successors.

(h) *Examples.* The following examples illustrate the provisions of this section. In each example, assume that the qualifying debt instrument is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the debt instrument is a debt instrument for federal income tax purposes.

Example 1. Issuer hedge—(i) Facts. On January 1, 1997, V, a domestic corporation, issues a 5-year debt instrument for \$1,000. The debt instrument provides for annual

payments of interest at a rate equal to the value of 1-year LIBOR and a principal payment of \$1,000 at maturity. On the same day, V enters into a 5-year interest rate swap agreement with an unrelated party. Under the swap, V pays 6 percent and receives 1-year LIBOR on a notional principal amount of \$1,000. The payments on the swap are fixed and made on the same days as the payments on the debt instrument. On January 1, 1997, V identifies the debt instrument and the swap as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The swap is a § 1.1275-6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. V has met the identification requirements, and 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 is a 5-year debt instrument that has an issue price of \$1,000 and provides for annual interest payments of \$60 and a principal payment of \$1,000 at maturity. 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 has a stated redemption price at maturity of \$1,300 (the sum of all amounts to be paid on the qualifying debt instrument and the swap, reduced by amounts to be received on the swap). The synthetic debt instrument, therefore, has \$300 of OID.

Example 2. Issuer hedge with an option—(i) Facts. On December 31, 1996, W, a domestic corporation, issues for \$1,000 a debt instrument that matures on December 31, 1999. The debt instrument has a stated principal amount of \$1,000 payable at maturity. The debt instrument also provides for a payment at maturity equal to \$10 times the increase, if any, in the value of a nationally known composite index of stocks from December 31, 1996, to the maturity date. On December 31, 1996, W purchases from an unrelated party an option that pays \$10 times the increase, if any, in the stock index from December 31, 1996, to December 31, 1999. W pays \$250 for the option. On December 31, 1996, W identifies the debt instrument and option as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The option is a § 1.1275-6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the option and the debt instrument can be calculated. W has met the identification requirements, and 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.* Under paragraph (f)(4) of this section, the issue price of the synthetic debt

instrument is equal to the issue price of the debt instrument (\$1,000) reduced by the payment for the option (\$250). As a result, the synthetic debt instrument is a 3-year debt instrument with an issue price of \$750. Under paragraph (f)(7) of this section, the synthetic debt instrument has a stated redemption price at maturity of \$1,000 (the \$250 payment for the option is not taken into account). The synthetic debt instrument, therefore, has \$250 of OID.

Example 3. Hedge with prepaid swap—(i) Facts. On January 1, 1997, H purchases for £1,000 a 5-year debt instrument that provides for semiannual payments based on 6-month pound LIBOR and a payment of the £1,000 principal at maturity. On the same day, H enters into a swap with an unrelated third party under which H receives semiannual payments, in pounds, of 10 percent, compounded semiannually, and makes semiannual payments, in pounds, of 6-month pound LIBOR on a notional principal amount of £1,000. Payments on the swap are fixed and made on the same dates as the payments on the debt instrument. H also makes a £162 prepayment on the swap. On January 1, 1997, H identifies the swap and the debt instrument as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* The debt instrument is a qualifying debt instrument. The swap is a § 1.1275-6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. Although the debt instrument is denominated in pounds, the swap hedges only interest rate risk, not currency risk. Therefore, the transaction is an integrated transaction under this section. See § 1.988-5(a) for the treatment of a debt instrument and a swap if the swap hedges currency risk.

(iii) *Treatment of the synthetic debt instrument.* Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument (£1,000) increased by the prepayment on the swap (£162). As a result, the synthetic debt instrument is a 5-year debt instrument that has an issue price of £1,162 and provides for semiannual interest payments of £50 and a principal payment of £1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is £1,500 (the sum of all amounts to be received on the qualifying debt instrument and the § 1.1275-6 hedge, reduced by all amounts to be paid on the § 1.1275-6 hedge other than the £162 prepayment for the swap). The synthetic debt instrument, therefore, has £338 of OID.

Example 4. Legging into an integrated transaction by a holder—(i) Facts. On December 31, 1996, X corporation purchases for \$1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest at the rate of 6 percent and for a payment at maturity equal to \$1,000,000, increased by the excess, if any, of the price of 1,000 units of a commodity on December 31, 2006, over

\$350,000, and decreased by the excess, if any, of \$350,000 over the price of 1,000 units of the commodity on that date. The projected amount of the payment at maturity determined under § 1.1275-4(b)(4) is \$1,020,000. On December 31, 1999, X enters into a cash-settled forward contract with an unrelated party to sell 1,000 units of the commodity on December 31, 2006, for \$450,000. On December 31, 1999, X also identifies the debt instrument and the forward contract as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration.* X meets the requirements for integration as of December 31, 1999. Therefore, X legged into an integrated transaction on that date. Prior to that date, X treats the debt instrument under the applicable rules of § 1.1275-4.

(iii) *Treatment of the synthetic debt instrument.* As of December 31, 1999, the debt instrument and the forward contract are treated as an integrated transaction. The issue price of the synthetic debt instrument is equal to the adjusted issue price of the qualifying debt instrument on the leg-in date, \$1,004,804 (assuming one year accrual periods). The term of the synthetic debt instrument is from December 31, 1999, to December 31, 2006. The synthetic debt instrument provides for annual interest payments of \$60,000 and a principal payment at maturity of \$1,100,000 (\$1,000,000 + \$450,000 - \$350,000). Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is \$1,520,000 (the sum of all amounts to be received by X on the qualifying debt instrument and the § 1.1275-6 hedge, reduced by all amounts to be paid by X on the § 1.1275-6 hedge). The synthetic debt instrument, therefore, has \$515,196 of OID.

Example 5. Abusive leg-in—(i) Facts. On January 1, 1997, Y corporation purchases for \$1,000,000 a debt instrument that matures on December 31, 2001. The debt instrument provides for annual payments of interest at the rate of 6 percent, a payment on December 31, 1999, of the increase, if any, in the price of a commodity from January 1, 1997, to December 31, 1999, and a payment at maturity of \$1,000,000 and the increase, if any, in the price of the commodity from December 31, 1999 to maturity. Because the debt instrument is a contingent payment debt instrument subject to § 1.1275-4, Y accrues interest based on the projected payment schedule.

(ii) *Leg-in.* By late 1999, the price of the commodity has substantially increased, and Y expects a positive adjustment on December 31, 1999. In late 1999, Y enters into an agreement to exchange the two commodity based payments on the debt instrument for two payments on the same dates of \$100,000 each. Y identifies the transaction as an integrated transaction in accordance with the requirements of paragraph (e) of this section. Y disposes of the hedge in early 2000.

(iii) *Treatment.* The legging into an integrated transaction has the effect of

deferring 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.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 18. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 19. Section 602.101, paragraph (c) is amended by:

1. Removing the following entries from the table:

§ 602.101 OMB Control numbers.

* * * * *
(c) * * *

CFR part or section where identified and described	Current OMB control No.
1.1272-1(c)(4)	1545-1353
1.1275-3(b)	1545-1353
1.1275-3(c)	1545-0887
* * * * *	* * * * *

2. Adding entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *
(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * *	*
1.1275-2	1545-1450
1.1275-3	1545-0887
	1545-1353
	1545-1450
1.1275-4	1545-1450
1.1275-6	1545-1450
* * * *	*

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: March 22, 1996.

Leslie Samuels,

Assistant Secretary of the Treasury.

[FR Doc. 96-14918 Filed 6-11-96; 8:45 am]

BILLING CODE 4830-01-P

PENSION BENEFIT GUARANTY CORPORATION

29 CFR Parts 2619 and 2676

Valuation of Plan Benefits in Single-Employer Plans; Valuation of Plan Benefits and Plan Assets Following Mass Withdrawal; Amendments Adopting Additional PBGC Rates

AGENCY: Pension Benefit Guaranty Corporation.

ACTION: Final rule.

SUMMARY: This final rule amends the Pension Benefit Guaranty Corporation's regulations on Valuation of Plan Benefits in Single-Employer Plans and Valuation of Plan Benefits and Plan Assets Following Mass Withdrawal. The former regulation contains the interest assumptions that the PBGC uses to value benefits under terminating single-employer plans. The latter regulation contains the interest assumptions for valuations of multiemployer plans that have undergone mass withdrawal. The amendments set out in this final rule adopt the interest assumptions applicable to single-employer plans with termination dates in July 1996, and to multiemployer plans with valuation dates in July 1996. The effect of these amendments is to advise the public of the adoption of these assumptions.

EFFECTIVE DATE: July 1, 1996.

FOR FURTHER INFORMATION CONTACT:

Harold J. Ashner, Assistant General Counsel, Office of the General Counsel, Pension Benefit Guaranty Corporation, 1200 K Street, NW., Washington, DC 20005, 202-326-4024 (202-326-4179 for TTY and TDD).

SUPPLEMENTARY INFORMATION: This rule adopts the July 1996 interest

assumptions to be used under the Pension Benefit Guaranty Corporation's regulations on Valuation of Plan Benefits in Single-Employer Plans (29 CFR part 2619, the "single-employer regulation") and Valuation of Plan Benefits and Plan Assets Following Mass Withdrawal (29 CFR part 2676, the "multiemployer regulation").

Part 2619 sets forth the methods for valuing plan benefits of terminating single-employer plans covered under title IV of the Employee Retirement Income Security Act of 1974, as amended. Under ERISA section 4041(c), all single-employer plans wishing to terminate in a distress termination must value guaranteed benefits and "benefit liabilities," *i.e.*, all benefits provided under the plan as of the plan termination date, using the formulas set forth in part 2619, subpart C. (Plans terminating in a standard termination may, for purposes of the Standard Termination Notice filed with PBGC, use these formulas to value benefit liabilities, although this is not required.) In addition, when the PBGC terminates an underfunded plan involuntarily pursuant to ERISA section 4042(a), it uses the subpart C formulas to determine the amount of the plan's underfunding. Part 2676 prescribes rules for valuing benefits and certain assets of multiemployer plans under sections 4219(c)(1)(D) and 4281(b) of ERISA.

Appendix B to part 2619 sets forth the interest rates and factors under the single-employer regulation. Appendix B to part 2676 sets forth the interest rates and factors under the multiemployer regulation. Because these rates and factors are intended to reflect current conditions in the financial and annuity markets, it is necessary to update the rates and factors periodically.

The PBGC issues two sets of interest rates and factors, one set to be used for the valuation of benefits to be paid as annuities and one set for the valuation of benefits to be paid as lump sums. The same assumptions apply to terminating single-employer plans and to multiemployer plans that have undergone a mass withdrawal. This amendment adds to appendix B to parts 2619 and 2676 sets of interest rates and factors for valuing benefits in single-employer plans that have termination dates during July 1996 and multiemployer plans that have undergone mass withdrawal and have valuation dates during July 1996.

For annuity benefits, the interest rates will be 6.20% for the first 20 years following the valuation date and 4.75% thereafter. For benefits to be paid as lump sums, the interest assumptions to

be used by the PBGC will be 5.00% for the period during which benefits are in pay status, 4.25% during the seven-year period directly preceding the benefit's placement in pay status, and 4.0% during any other years preceding the benefit's placement in pay status. These annuity and lump sum interest assumptions are unchanged from those in effect for June 1996.

Generally, the interest rates and factors under these regulations are in effect for at least one month. However, the PBGC publishes its interest assumptions each month regardless of whether they represent a change from the previous month's assumptions. The assumptions normally will be published in the Federal Register by the 15th of the preceding month or as close to that date as circumstances permit.

The PBGC has determined that notice and public comment on these amendments are impracticable and contrary to the public interest. This finding is based on the need to determine and issue new interest rates and factors promptly so that the rates and factors can reflect, as accurately as possible, current market conditions.

Because of the need to provide immediate guidance for the valuation of benefits in single-employer plans whose termination dates fall during July 1996, and in multiemployer plans that have undergone mass withdrawal and have valuation dates during July 1996, the PBGC finds that good cause exists for making the rates and factors set forth in this amendment effective less than 30 days after publication.

The PBGC has determined that this action is not a "significant regulatory action" under the criteria set forth in Executive Order 12866.

Because no general notice of proposed rulemaking is required for this amendment, the Regulatory Flexibility Act of 1980 does not apply. See 5 U.S.C. 601(2).

List of Subjects

29 CFR Part 2619

Employee benefit plans, Pension insurance, and Pensions.

29 CFR Part 2676

Employee benefit plans and Pensions. In consideration of the foregoing, parts 2619 and 2676 of chapter XXVI, title 29, Code of Federal Regulations, are hereby amended as follows:

PART 2619—[AMENDED]

1. The authority citation for part 2619 continues to read as follows:

Authority: 29 U.S.C. 1301(a), 1302(b)(3), 1341, 1344, 1362.