

IMMIGRANTS

Symbol	Class	Section of law
B25	Child of B24	203(d).
Family 2nd Preference (Exempt from Country Limitations)		
FX1	Spouse of Alien Resident	202(a)(4)(A) & 203(a)(2)(A).
FX2	Child of Alien Resident	202(a)(4)(A) & 203(a)(2)(A).
FX3	Child of FX1 and FX2	202(a)(4)(A) & 203(d) 203(a)(2)(A).
CX1	Spouse of Alien Resident (Conditional)	202(a)(4)(A) & 216.
CX2	Child of Alien Resident (Conditional)	202(a)(4)(A) & 216.
CX3	Child of CX1 & CX2 (Conditional)	202(a)(4)(A) & 203(d) & 216.
BX1	Self-petition Spouse of Lawful Permanent Resident	204(a)(1)(B)(ii).
BX2	Self-petition Child of Lawful Permanent Resident	204(a)(1)(B)(iii).
BX3	Child of BX1 or BX2	203(d).
Family 3rd Preference		
F31	Married Son or Daughter of U.S. Citizen	203(a)(3).
F32	Spouse of F31	203(d).
F33	Child of F31	302(d).
C31	Married Son or Daughter of U.S. Citizen (Conditional)	216(a)(1).
C32	Spouse of C31 (Conditional)	203(d) & 216.
C33	Child of C31 (Conditional)	203(d) & 216.
B31	Self-petition Married Son or Daughter of U.S. Citizen	204(a)(1)(A)(iv) & 203(a)(3).
B32	Spouse of B31	203(d).
B33	Child of B31	203(d).

* * * * *

Dated: November 21, 1996.

Mary A. Ryan,

Assistant Secretary for Consular Affairs.

[FR Doc. 97-135 Filed 1-3-97; 8:45 am]

BILLING CODE 4710-06-P

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Part 1****[TD 8709]****RIN 1545-AU44****Inflation-Indexed Debt Instruments****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Temporary and final regulations.

SUMMARY: This document contains temporary regulations relating to the federal income tax treatment of inflation-indexed debt instruments, including Treasury Inflation-Indexed Securities. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register. This document also contains amendments to

final regulations to reflect the addition of the temporary regulations. The regulations in this document provide needed guidance to holders and issuers of inflation-indexed debt instruments.

EFFECTIVE DATE: The regulations are effective January 6, 1997.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION:**Background**

The Department of the Treasury published final rules describing the terms and conditions of new debt instruments that it plans to issue. The payments on these debt instruments (Treasury Inflation-Indexed Securities) will be indexed for inflation and deflation.

On June 14, 1996, the IRS published final regulations in the Federal Register relating to certain debt instruments that provide for contingent payments (61 FR 30133). The preamble to the final regulations indicates that the noncontingent bond method described in § 1.1275-4(b) might be inappropriate for the Treasury Inflation-Indexed Securities. On October 15, 1996, the IRS published Notice 96-51 (1996-42 I.R.B. 6), which announced the IRS's intention

to issue temporary and proposed regulations that would provide guidance on the federal income tax treatment of the Treasury Inflation-Indexed Securities and other debt instruments with similar terms. This document contains the temporary regulations described in Notice 96-51.

Explanation of Provisions**A. In General**

The temporary regulations provide rules for the treatment of certain debt instruments that are indexed for inflation and deflation, including Treasury Inflation-Indexed Securities. The temporary regulations generally require holders and issuers of inflation-indexed debt instruments to account for interest and original issue discount (OID) using constant yield principles. In addition, the temporary regulations generally require holders and issuers of inflation-indexed debt instruments to account for inflation and deflation by making current adjustments to their OID accruals.

B. Applicability

The temporary regulations apply to inflation-indexed debt instruments. In general, an inflation-indexed debt instrument is a debt instrument that (1) Is issued for cash, (2) is indexed for inflation and deflation (as described

below), and (3) is not otherwise a contingent payment debt instrument. The temporary regulations do not apply, however, to certain debt instruments, such as debt instruments issued by qualified state tuition programs.

C. Indexing Methodology

A debt instrument is considered indexed for inflation and deflation if the payments on the instrument are indexed by reference to the change in value of a general price or wage index over the term of the instrument. Specifically, the amount of each payment on an inflation-indexed debt instrument must equal the product of (1) The amount of the payment that would be payable on the instrument (determined as if there were no inflation or deflation over the term of the instrument) and (2) the ratio of the value of the reference index for the payment date to the value of the reference index for the issue date.

The reference index for a debt instrument is the mechanism for measuring inflation and deflation over the term of the instrument. This mechanism associates the value of a single qualified inflation index for a particular month with a specified day of a succeeding month. For example, under the terms of the Treasury Inflation-Indexed Securities, the reference index for the first day of a month is the value of a qualified inflation index for the third preceding month. The reference index must be reset once a month to the current value of a qualified inflation index. Between reset dates, the value of the reference index is determined through straight-line interpolation.

A qualified inflation index is a general price or wage index that is updated and published at least monthly by an agency of the United States Government. A general price or wage index is an index that measures price or wage changes in the economy as a whole. An index is not general if it only measures price or wage changes in a particular segment of the economy. For example, the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), which is published by the Bureau of Labor Statistics of the Department of Labor, is a qualified inflation index because it measures general price changes in the economy. By contrast, the gasoline price component of the CPI-U is not a qualified inflation index because it only measures price changes in a particular segment of the economy.

D. Coupon Bond Method

The temporary regulations provide a simplified method of accounting for qualified stated interest and inflation adjustments on certain inflation-indexed debt instruments (the coupon bond method). To qualify for the coupon bond method, an inflation-indexed debt instrument must satisfy two conditions. First, there must be no more than a de minimis difference between the debt instrument's issue price and its principal amount for the issue date. Second, all stated interest on the debt instrument must be qualified stated interest. Because Treasury Inflation-Indexed Securities that are not stripped into principal and interest components satisfy both of these conditions, the coupon bond method applies to these securities.

If an inflation-indexed debt instrument qualifies for the coupon bond method, the stated interest payable on the debt instrument is taken into account under the taxpayer's regular method of accounting. Any increase in the inflation-adjusted principal amount is treated as OID for the period in which the increase occurs. Any decrease in the inflation-adjusted principal amount is taken into account under the rules for deflation adjustments described below.

For example, if a taxpayer holds a Treasury Inflation-Indexed Security for an entire calendar year and the taxpayer uses the cash receipts and disbursements method of accounting (cash method), the taxpayer generally includes in income the interest payments received on the security during the year. In addition, the taxpayer includes in income an amount of OID measured by subtracting the inflation-adjusted principal amount of the security at the beginning of the year from the inflation-adjusted principal amount of the security at the end of the year. If the taxpayer uses an accrual method of accounting rather than the cash method, the taxpayer includes in income the qualified stated interest that accrued on the debt instrument during the year and an amount of OID measured by subtracting the inflation-adjusted principal amount of the security at the beginning of the year from the inflation-adjusted principal amount of the security at the end of the year.

E. Discount Bond Method

If an inflation-indexed debt instrument does not qualify for the coupon bond method (for example, because it is issued at a discount), the instrument is subject to the discount bond method. In general, the discount

bond method requires holders and issuers to make current adjustments to their OID accruals to account for inflation and deflation.

Under the discount bond method, a taxpayer determines the amount of OID allocable to an accrual period by using steps similar to those provided in § 1.1272-1(b)(1). First, the taxpayer determines the yield to maturity of the debt instrument as if there were no inflation or deflation over the term of the instrument. Second, the taxpayer determines the length of the accrual periods to be used to allocate OID over the term of the debt instrument, provided no accrual period is longer than one month. Third, the taxpayer determines the percentage change in the value of the reference index during the accrual period by comparing the value at the beginning of the period to the value at the end of the period. Fourth, the taxpayer determines the OID allocable to the accrual period by using a formula that takes into account both the yield of the debt instrument and the percentage change in the value of the reference index during the period. Fifth, the taxpayer allocates to each day in the accrual period a ratable portion of the OID for the accrual period (the daily portions). If the daily portions for an accrual period are positive amounts, these amounts are taken into account under section 163(e) by an issuer and under section 1272 by a holder. If the daily portions for an accrual period are negative amounts, these amounts are taken into account under the rules for deflation adjustments described below.

Under Notice 96-51, the discount bond method would have allowed qualified stated interest. The temporary regulations, however, provide that no interest payments on an inflation-indexed debt instrument subject to the discount bond method are qualified stated interest. The Treasury and the IRS believe that this change simplifies the taxation of an inflation-indexed debt instrument subject to the discount bond method.

F. Deflation Adjustments

The temporary regulations treat deflation adjustments in a manner consistent with the treatment of net negative adjustments on contingent payment debt instruments under § 1.1275-4(b)(6)(iii). If a holder has a deflation adjustment for a taxable year, the deflation adjustment first reduces the amount of interest otherwise includible in income with respect to the debt instrument for the taxable year. If the amount of the deflation adjustment exceeds the interest otherwise includible in income for the taxable

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

G. Minimum Guarantee

Certain inflation-indexed debt instruments may provide for an additional payment at maturity (a minimum guarantee payment) if the total amount of inflation-adjusted principal paid on the debt instrument is less than the instrument's stated principal amount. Under both the coupon bond method and the discount bond method, a minimum guarantee payment is ignored until the payment is made. If a minimum guarantee payment is made, the payment is treated as interest on the date it is paid.

In general, the temporary regulations only allow a debt instrument that is indexed by reference to the CPI-U to provide for a minimum guarantee payment. The Treasury and the IRS believe that there is only a small possibility that the total amount of principal paid on a debt instrument indexed to the CPI-U will be less than the instrument's stated principal amount. In this case, it is appropriate to ignore the minimum guarantee payment until it is paid.

H. Principal Amount for the Issue Date

For purposes of the temporary regulations, if an inflation-indexed debt instrument is issued with pre-issuance accrued interest, the principal amount of the instrument for the issue date includes an adjustment for inflation or deflation. This adjustment is measured by the change in the value of the reference index between the date on which interest starts to accrue (the dated date in the case of a Treasury Inflation-Indexed Security) and the issue date. The stated principal amount of a debt instrument under the regulations, however, is not adjusted for inflation or deflation between the date on which interest starts to accrue and the issue

date. Therefore, the stated principal amount of the debt instrument is the same regardless of whether interest accrues on the instrument from the issue date or from an earlier date. The stated principal amount of a Treasury Inflation-Indexed Security is the par amount of the security, as defined in the final rules published by the Treasury Department describing the terms and conditions of Treasury Inflation-Indexed Securities.

When there is a difference between the stated principal amount of an inflation-indexed debt instrument and its principal amount for the issue date, the instrument's principal amount for the issue date generally is used for purposes of applying the rules in the temporary regulations to the instrument. For example, the debt instrument's principal amount for the issue date is used to determine whether the instrument qualifies for the coupon bond method. The temporary regulations require the use of a debt instrument's stated principal amount rather than its principal amount for the issue date to measure the amount of a minimum guarantee payment.

I. Strips

Treasury Inflation-Indexed Securities are eligible for the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program. Under this program, the interest and principal components of a Treasury Inflation-Indexed Security may be transferred as separate instruments (stripped bonds and coupons). In general, section 1286 treats the holder of a stripped bond (or coupon) as if the holder purchased a newly issued debt instrument that has OID. The temporary regulations provide that the holder of a component of a Treasury Inflation-Indexed Security that is stripped under the Treasury STRIPS program must use the discount bond method to account for the OID on the component.

J. Information Reporting

The temporary regulations do not provide any new information reporting rules for inflation-indexed debt instruments. The OID and any qualified stated interest on an inflation-indexed debt instrument should be reported on Form 1099-OID. The IRS plans to issue guidance for the reporting of OID on Treasury Inflation-Indexed Securities that are stripped under the STRIPS program.

K. Effective Date

The temporary regulations apply to an inflation-indexed debt instrument issued on or after January 6, 1997.

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) does not apply to these regulations and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of the regulations is Jeffrey W. Maddrey, Office of Assistant Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding two entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.1275-7T also issued under 26 U.S.C. 1275(d). * * *
Section 1.1286-2T also issued under 26 U.S.C. 1286(f). * * *

Par. 2. Section 1.1271-0 is amended by—

1. Revising the second sentence of paragraph (a);
2. Revising the introductory text of paragraph (b); and
3. Adding entries for § 1.1275-7T in paragraph (b).

The revisions and additions read as follows:

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

(a) * * * Taxpayers, however, may rely on these sections (as contained in

26 CFR part 1 revised April 1, 1996) for debt instruments issued after December 21, 1992, and before April 4, 1994.

(b) *Table of contents.* This section lists captioned paragraphs contained in §§ 1.1271-1 through 1.1275-7T.

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§ 1.1275-7T Inflation-indexed debt instruments (temporary).

(a) Overview.

(b) Applicability.

(1) In general.

(2) Exceptions.

(c) Definitions.

(1) Inflation-indexed debt instrument.

(2) Reference index.

(3) Qualified inflation index.

(4) Inflation-adjusted principal amount.

(5) Minimum guarantee payment.

(d) Coupon bond method.

(1) In general.

(2) Applicability.

(3) Qualified stated interest.

(4) Inflation adjustments.

(5) Example.

(e) Discount bond method.

(1) In general.

(2) No qualified stated interest.

(3) OID.

(4) Example.

(f) Special rules.

(1) Deflation adjustments.

(2) Adjusted basis.

(3) Subsequent holders.

(4) Minimum guarantee.

(5) Temporary unavailability of a qualified inflation index.

(g) Reopenings.

(h) Effective date.

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§ 1.1275.4 [Amended]

Par. 3. Section 1.1275-4 is amended by—

1. Removing the word “or” from the end of paragraph (a)(2)(vi);

2. Redesignating paragraph (a)(2)(vii) as paragraph (a)(2)(viii); and

3. Adding a new paragraph (a)(2)(vii). The addition reads as follows:

§ 1.1275-4 Contingent payment debt instruments.

(a) * * *

(2) * * *

(vii) An inflation-indexed debt instrument (as defined in § 1.1275-7T); or

* * * * *

Par. 4. Section 1.1275-7T is added to read as follows:

§ 1.1275-7T Inflation-indexed debt instruments (temporary).

(a) *Overview.* This section provides rules for the federal income tax treatment of an inflation-indexed debt instrument. If a debt instrument is an inflation-indexed debt instrument, one of two methods will apply to the instrument: the coupon bond method

(as described in paragraph (d) of this section) or the discount bond method (as described in paragraph (e) of this section). Both methods determine the amount of OID that is taken into account each year by a holder or an issuer of an inflation-indexed debt instrument.

(b) *Applicability—(1) In general.* Except as provided in paragraph (b)(2) of this section, this section applies to an inflation-indexed debt instrument as defined in paragraph (c)(1) of this section. For example, this section applies to Treasury Inflation-Indexed Securities.

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

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

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

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

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

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

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

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

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

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

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

(B) Payments under one or more alternate payment schedules if the

payments under each payment schedule are indexed for inflation and deflation and a payment schedule for the debt instrument can be determined under § 1.1272-1(c). (For purposes of this section, the rules of § 1.1272-1(c) are applied to the debt instrument by assuming that no inflation or deflation will occur over the term of the instrument.)

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

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

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

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

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

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

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

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

(5) *Minimum guarantee payment.* In general, a minimum guarantee payment is an additional payment made at maturity on a debt instrument if the total amount of inflation-adjusted principal paid on the instrument is less than the instrument's stated principal amount. The amount of the additional payment must be no more than the excess, if any, of the debt instrument's stated principal amount over the total amount of inflation-adjusted principal paid on the instrument. An additional payment is not a minimum guarantee

payment unless the qualified inflation index used to determine the reference index is either the CPI-U or an index designated for this purpose by the Commissioner in the Federal Register or the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter). See paragraph (f)(4) of this section for the treatment of a minimum guarantee payment.

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

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

(i) *Issued at par.* The debt instrument is issued at par. A debt instrument is issued at par if the difference between its issue price and principal amount for the issue date is less than the de minimis amount. For this purpose, the de minimis amount is determined using the principles of § 1.1273-1(d).

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

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

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

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

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

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

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

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

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

Example. (i) *Facts.* On October 15, 1997, X purchases at original issue, for \$100,000, a debt instrument that is indexed for inflation and deflation. The debt instrument matures on October 15, 1999, has a stated principal amount of \$100,000, and has a stated interest rate of 5 percent, compounded semiannually. The debt instrument provides that the principal amount is indexed to the CPI-U. Interest is payable on April 15 and October 15 of each year. The amount of each interest payment is determined by multiplying the inflation-adjusted principal amount for each interest payment date by the stated interest rate, adjusted for the length of the accrual period. The debt instrument provides for a single payment of the inflation-adjusted principal amount at maturity. In addition, the debt instrument provides for an additional payment at maturity equal to the excess, if any, of \$100,000 over the inflation-adjusted principal amount at maturity. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

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

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

issue date (\$100,000) and because all stated interest is qualified stated interest, the coupon bond method applies to the instrument.

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

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

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

(vi) *Treatment of X in 1998.* In 1998, X receives two payments of interest: On April 15, 1998, X receives a payment of \$2,575 ($\$100,000 \times 103/100 \times .05/2$), and on October 15, 1998, X receives a payment of \$2,625 ($\$100,000 \times 105/100 \times .05/2$). Therefore, X's qualified stated interest income for 1998 is \$5,200 (\$2,575 + \$2,625). X also must take into account the inflation adjustment for 1998. The inflation-adjusted principal amount for January 1, 1999, is \$99,000 ($\$100,000 \times 99/100$). Therefore, the inflation adjustment for 1998 is negative \$2,000, the inflation-adjusted principal amount for January 1, 1999 (\$99,000) minus the inflation-adjusted principal amount for January 1, 1998 (\$101,000). Because the amount of the inflation adjustment is negative, it is a deflation adjustment. Under paragraph (f)(1)(i) of this section, X uses this \$2,000 deflation adjustment to reduce the interest otherwise includible in income by X with respect to the debt instrument in 1998. Therefore, X includes \$3,200 in income for 1998, the qualified stated interest income for 1998 (\$5,200) minus the deflation adjustment (\$2,000).

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

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

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

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

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

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

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

(B) Minus one.

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

$$\text{OID}_{(n)} = \text{AIP}_{(n)} \times [r + \text{inf}_{(n)} + (r \times \text{inf}_{(n)})]$$

in which,

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

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

$\text{AIP}_{(n)}$ = adjusted issue price at the beginning of period (n).

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

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

Example. (i) Facts. On November 15, 1997, X purchases at original issue, for \$91,403, a zero-coupon debt instrument that is indexed for inflation and deflation. The principal amount of the debt instrument for the issue date is \$100,000. The debt instrument provides for a single payment on November 15, 2000. The amount of the payment will be determined by multiplying \$100,000 by a fraction, the numerator of which is the CPI-U for September 2000, and the denominator of which is the CPI-U for September 1997. The debt instrument also provides that in no

event will the payment on November 15, 2000, be less than \$100,000. X uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year.

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

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

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

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

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

(1) *Deflation adjustments—(i) Holder.* A deflation adjustment reduces the amount of interest otherwise includible

in income by a holder with respect to the debt instrument for the taxable year. For purposes of this paragraph (f)(1)(i), interest includes OID, qualified stated interest, and market discount. If the amount of the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year, the excess is treated as an ordinary loss by the holder for the taxable year. However, the amount treated as an ordinary loss is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior taxable years exceed the total amount treated by the holder as an ordinary loss on the debt instrument in prior taxable years. If the deflation adjustment exceeds the interest otherwise includible in income by the holder with respect to the debt instrument for the taxable year and the amount treated as an ordinary loss for the taxable year, this excess is carried forward to reduce the amount of interest otherwise includible in income by the holder with respect to the debt instrument for subsequent taxable years.

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

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

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

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

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

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

(g) *Reopenings.* For purposes of § 1.1275-2(d)(2), a reopening of Treasury Inflation-Indexed Securities is a qualified reopening if—

(1) The terms of the securities issued in the reopening are the same as the terms of the original securities; and

(2) The reopening occurs not more than one year after the original securities were first issued to the public.

(h) *Effective date.* This section applies to an inflation-indexed debt instrument issued on or after January 6, 1997.

Par. 5. Section 1.1286-2T is added to read as follows:

§ 1.1286-2T Stripped inflation-indexed debt instruments (temporary).

Stripped inflation-indexed debt instruments. If a Treasury Inflation-Indexed Security is stripped under the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program, the holders of the principal and coupon components must use the discount bond method (as described in § 1.1275-7T(e)) to account for the original issue discount on the components.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: December 6, 1996.

Donald C. Lubick,

Acting Assistant Secretary of the Treasury.

[FR Doc. 96-33398 Filed 12-31-96; 12:57 pm]

BILLING CODE 4830-01-U

Fiscal Service

31 CFR Part 354

Regulations Governing Book-Entry Securities of the Student Loan Marketing Association (Sallie Mae)

AGENCY: Bureau of the Public Debt, Fiscal Service, Treasury.

ACTION: Final rule.

SUMMARY: The Department of the Treasury, on behalf of the Student Loan Marketing Association, is publishing final regulations to govern Sallie Mae book-entry securities. This action is being taken in conjunction with similar amendments being made by the Department of the Treasury to the regulations governing book-entry Treasury securities, and by other government-sponsored enterprises (GSEs) for GSE securities that are maintained on the book-entry system operated by the Federal Reserve Banks. The rules incorporate recent and significant changes in commercial law addressing the holding of securities in book-entry form through financial intermediaries.

EFFECTIVE DATE: January 6, 1997. The incorporation by reference of certain publications listed in the regulations is approved by the Director of the Federal Register as of January 6, 1997.

FOR FURTHER INFORMATION CONTACT:

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SUPPLEMENTARY INFORMATION: Virtually all government-sponsored enterprises (GSEs) have regulations governing their book-entry securities maintained in the Federal Reserve book-entry system that are nearly identical to the regulations governing marketable Treasury securities.¹

In the case of the Student Loan Marketing Association ("Sallie Mae"), the Secretary of the Treasury is expressly authorized by the Higher Education Act of 1965, as amended,² to promulgate Sallie Mae's book-entry regulations. The current Sallie Mae book-entry regulations were issued by Treasury pursuant to that authority and appear in 31 CFR Part 354.³ The regulations set forth rules for the transfer, pledge and servicing of book-entry Sallie Mae securities.

The current Treasury regulations will be superseded by new regulations (the "TRADES regulations")⁴ that will go into effect January 1, 1997. As explained below, the TRADES regulations incorporate recent and significant changes in commercial law addressing the holding of securities in book-entry form through financial intermediaries.⁵

Some commenters on the TRADES regulations were concerned about coordination among Treasury and the GSEs. The commenters urged simultaneous effectiveness of parallel GSE rules. Accordingly, pursuant to Sallie Mae's request, Treasury is issuing revised regulations that will be effective in January, 1997, for Sallie Mae securities maintained on the Federal Reserve book-entry system.

Consistent with the approach in the TRADES regulations, the regulations in this Part contain specific provisions that deal with the rights and obligations of Sallie Mae and the Federal Reserve Banks with respect to Sallie Mae securities and the operation of the book-entry system. The regulations are also based in large part on Revised Article 8 on Investment Securities of the Uniform

¹ 31 CFR Part 306, Subpart O.

² P.L. No. 99-498, 20 U.S.C. § 1087-2(m).

³ 52 FR 4495 (February 12, 1987). Prior to that time, Treasury had promulgated book-entry regulations only for Sallie Mae securities issued February 25, 1983 through September 30, 1983 (48 FR 8059).

⁴ 61 FR 43626 (August 23, 1996).

⁵ At the time the Sallie Mae regulations were issued, it was noted in the preamble that once the TRADES regulations were finalized, it was contemplated that the Sallie Mae regulations would be replaced with a similar set of rules.