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IRS Publishes Final Regs on Bond Premium Carryforwards.

The IRS has published final regulations (T.D. 9653) that provide guidance on the tax treatment of a debt instrument with a bond premium carryforward in the holder's final accrual period.

Effective January 15, 2014, the final regs adopt, without substantive change, proposed regs (REG-140437-12) issued in January 2013. Corresponding temporary regs (T.D. 9609) are removed. The final regs provide guidance to holders of Treasury securities and other debt instruments acquired at a premium.

Before the temporary regs were issued, Treasury and the IRS received inquiries about a holder's treatment of a taxable zero coupon debt instrument acquired at a premium and having a negative yield. In that situation, under the then-existing bond premium regs, a holder that elected to amortize the bond premium generally would have a capital loss on the sale, retirement, or other disposition of the debt instrument rather than an ordinary deduction under section 171(a)(1) for all or a portion of the bond premium.

If a zero coupon debt instrument is acquired at a premium, the bond premium allocable to an accrual period is carried forward to the next accrual period and to each succeeding accrual period. As a result, on the sale, retirement, or other disposition of the debt instrument, there generally will be a bond premium carryforward in the holder's final accrual period. Under the prior bond premium regs, the holder would have a capital loss in an amount at least equal to the bond premium carryforward because there is no qualified stated interest to offset the bond premium carryforward and the holder's basis in the bond has not been reduced. The acquisition of a zero coupon debt instrument at a premium and with a negative yield was not contemplated when the prior regs were adopted in 1997.

To address this situation, the temporary regs added a specific rule for the treatment of a bond premium carryforward determined as of the end of the holder's final accrual period for any taxable debt instrument for which the holder has elected to amortize bond premium. The final regs adopt that rule and, thus, an electing holder deducts all or a portion of the bond premium under section 171(a)(1) when the instrument is sold, retired, or otherwise disposed of rather than recognizing a capital loss.

The final regs apply to a debt instrument acquired after January 3, 2013, but a taxpayer may rely on the regs for a debt instrument acquired before that date.

Bond Premium Carryforward

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

Treasury Decision 9653

RIN 1545-BL28

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance on the tax treatment of a debt instrument with a bond premium carryforward in the holder's final accrual period. The regulations in this document provide guidance to holders of Treasury securities and other debt instruments acquired at a premium.

DATES: Effective Date: These regulations are effective on January 15, 2014.

Applicability Date: For the date of applicability, see § 1.171-2(a)(4)(i)(C)(2).

FOR FURTHER INFORMATION CONTACT: William E. Blanchard, (202) 317-3900 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 4, 2013, the IRS and the Treasury Department published temporary regulations (TD 9609) in the Federal Register (78 FR 666) relating to the federal income tax treatment of a debt instrument with a bond premium carryforward in the holder's final accrual period, including a Treasury bill acquired at a premium. See § 1.171-2T. On the same day, the IRS and the Treasury Department published a notice of proposed rulemaking (REG-140437-12) cross-referencing the temporary regulations in the Federal Register (78 FR 687). No comments were received on the notice of proposed rulemaking. No public hearing was requested or held.

The proposed regulations are adopted without substantive change by this Treasury decision, and the corresponding temporary regulations are removed.

Explanation of provisions

Prior to the issuance of the temporary regulations, the IRS and the Treasury Department had received questions about an electing holder's treatment of a taxable zero coupon debt instrument, including a Treasury bill, acquired at a premium and with a negative yield. In this situation, as explained in more detail below, under the bond premium regulations in effect prior to the issuance of the temporary regulations (the prior regulations), a holder that had elected to amortize bond premium under section 171 generally would have had a capital loss upon the sale, retirement, or other disposition of the debt instrument rather than an ordinary deduction under section 171(a)(1) for all or a portion of the bond premium. The acquisition of a zero coupon debt instrument at a premium and with a negative yield was not contemplated when the prior regulations were revised in 1997 (TD 8746).

Under section 171(c) and § 1.171-4, a holder can elect to amortize bond premium on taxable debt instruments. A holder acquires a debt instrument at a premium if the holder's basis in the debt instrument immediately after its acquisition by the holder exceeds the sum of all amounts payable on the debt instrument after the acquisition date other than payments of qualified stated interest (as defined in § 1.1273-1(c)). The general effect of an election to amortize bond premium on a debt

instrument that is a capital asset is to treat the bond premium as an offset to ordinary income rather than as a capital loss.

Under section 171(e) and § 1.171-2, an electing holder amortizes bond premium by offsetting the qualified stated interest allocable to an accrual period with the bond premium allocable to the period. As a result, the holder only includes the net amount of interest in income for the period. If the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the holder treats the excess as a bond premium deduction under section 171(a)(1) for the accrual period. However, the amount treated as a bond premium deduction is limited to the amount by which the holder's total interest inclusions on the debt instrument in prior accrual periods exceed the total amount treated by the holder as a bond premium deduction on the debt instrument in prior accrual periods. If the bond premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as a deduction under section 171(a)(1), the excess is carried forward to the next accrual period and is treated as bond premium allocable to that period. See § 1.171-2(a)(4). Under § 1.1016-5(b), a holder's basis in a taxable debt instrument is reduced by the amount of bond premium used to offset qualified stated interest on the debt instrument and the amount of bond premium allowed as a deduction under section 171(a)(1).

There is no stated interest payable, and therefore no qualified stated interest, on a zero coupon debt instrument, including a Treasury bill. As a result, under § 1.171-2, if a zero coupon debt instrument is acquired at a premium (that is, acquired for an amount greater than its stated principal amount), the bond premium allocable to an accrual period is carried forward to the next accrual period and to each succeeding accrual period. As a result, upon the sale, retirement, or other disposition of the debt instrument, there generally will be a bond premium carryforward in the holder's final accrual period. In this situation, because there is no qualified stated interest to offset the bond premium carryforward and the holder's basis in the debt instrument has not been reduced, under the prior regulations the holder would have had a capital loss in an amount at least equal to the bond premium carryforward.

To address the treatment of a bond premium carryforward in the situation described in the prior paragraph, the temporary regulations added a specific rule for the treatment of a bond premium carryforward determined as of the end of the holder's final accrual period for any taxable debt instrument for which the holder had elected to amortize bond premium. These final regulations adopt the rule in the temporary and proposed regulations. Thus, in the situation described in the prior paragraph, under these final regulations an electing holder deducts all or a portion of the bond premium under section 171(a)(1) when the instrument is sold, retired, or otherwise disposed of rather than recognizing a capital loss.

As noted above, no comments were received on the temporary regulations. The final regulations in this document are substantively the same as the temporary regulations.

Applicability Date

Section 1.171-2(a)(4)(i)(C)(1) applies to a debt instrument (bond) acquired on or after January 4, 2013 (the effective/applicability date of the temporary regulations). A taxpayer, however, may rely on this section for a debt instrument (bond) acquired before that date.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory

assessment is not required. It has also 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 Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. No comments were received.

Drafting Information

The principal author of these regulations is William E. Blanchard, Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the 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 removing the entry for § 1.171-2T to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.171-2 is amended by adding new paragraph (a)(4)(i)(C) to read as follows:

§ 1.171-2 Amortization of bond premium.

(a) * * *

(4) * * *

(i) * * *

(C) Carryforward in holder's final accrual period — (1) Bond premium deduction. If there is a bond premium carryforward determined under paragraph (a)(4)(i)(B) of this section as of the end of the holder's accrual period in which the bond is sold, retired, or otherwise disposed of, the holder treats the amount of the carryforward as a bond premium deduction under section 171(a)(1) for the holder's taxable year in which the sale, retirement, or other disposition occurs. For purposes of § 1.1016-5(b), the holder's basis in the bond is reduced by the amount of bond premium allowed as a deduction under this paragraph (a)(4)(i)(C)(1).

(2) Effective/applicability date. Notwithstanding § 1.171-5(a)(1), paragraph (a)(4)(i)(C)(1) of this section applies to a bond acquired on or after January 4, 2013. A taxpayer, however, may rely on paragraph (a)(4)(i)(C)(1) of this section for a bond acquired before that date.

* * * * *

§ 1.171-2T [Removed]

Par. 3. Section 1.171-2T is removed.

Par. 4. Section 1.171-3 is amended by revising the fifth sentence in paragraph (b) to read as follows:

§ 1.171-3 Special rules for certain bonds.

* * * * *

(b) * * * However, the rules in § 1.171-2(a)(4)(i)(C) apply to any remaining deflation adjustment attributable to bond premium as of the end of the holder's accrual period in which the bond is sold, retired, or otherwise disposed of. * * *

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John Dalrymple

Deputy Commissioner for Services

and Enforcement.

Approved: January 7, 2014

Mark J. Mazur

Assistant Secretary of the

Treasury (Tax Policy).

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