Part III - Administrative, Procedural, and Miscellaneous

Inflation-Indexed Debt Instruments

Notice 96-51

The Department of the Treasury plans to issue securities that are adjusted for inflation and deflation ("Treasury Inflation-Protection Securities"). See Amendment to the Uniform Offering Circular for the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes and Bonds, which was filed with the Federal Register on September 25, 1996. To provide guidance on the federal income tax treatment of these securities and other debt instruments with similar terms, the Internal Revenue Service (IRS) intends to issue proposed and temporary regulations under §§ 1275(d) and 1286 of the Internal Revenue Code prior to the first issuance of the securities. This notice describes, in general terms, the debt instruments that are expected to be subject to the regulations and how these instruments are expected to be treated under the regulations.

TREASURY INFLATION-PROTECTION SECURITIES

As described in the Offering Circular, a Treasury Inflation-Protection Security will provide for semiannual payments of interest and a payment of principal at maturity. In general, each payment will be adjusted to take into account any inflation or deflation that occurs between the issue date of the security and the payment date.

The principal amount of a Treasury Inflation-Protection Security will be adjusted for inflation and deflation based on monthly changes in 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. The inflation-adjusted principal amount of the security for the first day of any month will be determined by multiplying the principal amount at issuance by a fraction, the numerator of which is the value of the index for the adjustment date and the denominator of which is the value of the index for the issue date. The inflation-adjusted principal amount of the security for a day other than the first day of a month will be determined based on a straight-line interpolation between the inflation-adjusted principal amount for the first day of the month and the inflation-adjusted principal amount for the first day of the next month. The value of the index used to determine the adjustment for the first day of a particular month will be the value of the index reported for the third preceding month.

Each semiannual payment of interest will be determined by multiplying a single fixed rate of interest by the inflation-adjusted principal amount of the security for the date of the interest payment. Thus, although the interest rate will be fixed, the amount of each interest payment will vary with changes in the principal of the security as adjusted for inflation and deflation.

A Treasury Inflation-Protection Security also will provide for an additional payment at maturity if the security's inflation-adjusted principal amount for the maturity date is less than the security's principal amount at issuance. The amount of the additional payment will equal the excess of the security's principal amount at issuance over the security's inflation-adjusted principal amount for the maturity date.

INFLATION-INDEXED DEBT INSTRUMENTS

In general, the regulations will apply to an inflation-indexed debt instrument, regardless of the identity of the issuer. An inflation-indexed debt instrument generally will be defined in the regulations as a debt instrument that satisfies the following conditions:

(1) The debt instrument is issued for U.S. dollars and all payments of principal and interest on the instrument are denominated in U.S. dollars.

(2) The principal amount of the debt instrument is adjusted for inflation and deflation. The adjustment must be measured by changes in the current value of a single general price or wage index published monthly by an agency of the United States Government (e.g., the CPI-U). A current value of an index is a value of the index that has been updated and published within the six month period preceding the date of the adjustment.

(3) The debt instrument provides for an appropriate method to calculate its inflation-adjusted principal amount for each day to reflect the monthly changes in the current value of the price

or wage index. For example, the inflation-adjusted principal amount for the first day of each month is determined by reference to the change in the index for the third preceding month, and the inflation-adjusted principal amount for any other day is determined based on straight-line interpolation between the inflation-adjusted principal amount for the first day of the month and the inflation-adjusted principal amount for the first day of the next month.

(4) Each stated interest payment on the debt instrument, if any, is computed by multiplying a single fixed rate of interest by the inflation-adjusted principal amount for the date of the interest payment.

(5) The payments on the debt instrument are not subject to any contingencies other than the inflation contingency. For this purpose, a contingency that is remote or incidental will be ignored. In addition, a payment will not be contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

Notwithstanding the condition described in paragraph (5) above, a debt instrument will not fail to qualify as an inflation-indexed debt instrument merely because it provides for a minimum guarantee payment. A minimum guarantee payment is an additional payment that is made at maturity if the debt instrument's inflation-adjusted principal amount for the maturity date is less than the instrument's principal amount at issuance. The amount of the additional payment must be no more than the

excess of the debt instrument's principal amount at issuance over the instrument's inflation-adjusted principal amount for the maturity date.

An example of a debt instrument that satisfies the above conditions is a Treasury Inflation-Protection Security.

If a debt instrument qualifies as an inflation-indexed debt instrument, one of two methods will apply to account for qualified stated interest and original issue discount (OID) on the instrument: the coupon bond method or the discount bond method. In general, both methods will measure the amount of qualified stated interest and OID that accrues on an inflation-indexed debt instrument based on changes in the principal amount of the debt instrument and constant yield principles.

The discount bond method will apply a formula to determine the amount of OID that accrues during an accrual period on an inflation-indexed debt instrument. This formula is based on changes in the inflation index over the term of the debt instrument and the yield of the debt instrument at issuance. In the case of certain inflation-indexed debt instruments, however, the accruals of OID on the debt instruments can easily be determined without the use of the formula. Therefore, the regulations will provide a simplified version of the discount bond method for these debt instruments (the coupon bond method).

COUPON BOND METHOD

The coupon bond method will apply to an inflation-indexed debt instrument that satisfies two conditions: First, there is

no more than a de minimis difference between the debt instrument's issue price and its principal amount at issuance. Second, all stated interest payable on the debt instrument is qualified stated interest. For purposes of the regulations, stated interest will be qualified stated interest if it is unconditionally payable in cash at least annually. The coupon bond method will apply to Treasury Inflation-Protection Securities that are not stripped into principal and interest components.

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

For example, if a taxpayer who uses the cash receipts and disbursements method of accounting (cash method) holds a Treasury Inflation-Protection Security for an entire calendar year, the taxpayer generally will include in income the interest payments received on the security during the year. In addition, the taxpayer will include in income an amount of OID measured by subtracting the inflation-adjusted principal amount of the security for January 1 of the year from the inflation-adjusted

principal amount of the security for January 1 of the next year. If the taxpayer uses an accrual method of accounting rather than the cash method, the taxpayer will include 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 for January 1 of the year from the inflation-adjusted principal amount of the security for January 1 of the next year.

DISCOUNT BOND METHOD

If an inflation-indexed debt instrument does not qualify for the coupon bond method (e.g., because it is issued at a discount), the instrument will be subject to the discount bond method. In general, the discount bond method will require taxpayers to make current adjustments to their OID accruals on the debt instrument to account for changes in the inflation-adjusted principal amount.

Under the discount bond method, a taxpayer will accrue OID using the four steps provided under § 1.1272-1(b)(1) of the Income Tax Regulations (constant yield method). However, the debt instrument's yield to maturity will be determined as of the issue date by assuming no inflation or deflation, and the OID allocable to an accrual period (n) will be determined by using the following formula:

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

where,

r = yield of the debt instrument determined as of the issue date by assuming no inflation or deflation, adjusted for the length of the accrual period;

$inf_{(n)}$ = percentage change in the inflation index for period (n);

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

$QSI_{(n)}$ = qualified stated interest allocable to period (n).

If the formula produces a negative amount of OID, this amount (deflation adjustment) will be taken into account under the rules for deflation adjustments described below.

DEFLATION ADJUSTMENTS

In general, a deflation adjustment will reduce the amount of interest includible in income by a holder 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 excess will be treated as an ordinary loss by the holder for the taxable year. However, the amount treated as an ordinary loss will be 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 will be carried

forward to offset interest income on the debt instrument in subsequent taxable years. In general, any excess remaining upon the sale, exchange, or retirement of the debt instrument will result in a loss to the holder for federal income tax purposes. Similar rules will apply to determine an issuer's interest deductions and income for the debt instrument.

MINIMUM GUARANTEE

Under both the coupon bond method and the discount bond method, a minimum guarantee payment as described above generally will be ignored until the payment is made. If there is a minimum guarantee payment, the payment will be treated as a payment of interest.

ACCRUALS OF QUALIFIED STATED INTEREST

In certain situations, a taxpayer will have to determine how much qualified stated interest, if any, has accrued as of a certain date on an inflation-indexed debt instrument. The regulations will provide that 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 will determine the amount of accrued qualified stated interest for the first taxable year by reference to the inflation-adjusted principal amount for the last day of the taxable year.

SUBSEQUENT HOLDERS

For purposes of determining whether a holder acquires an inflation-indexed debt instrument at a premium or with market discount, the amount payable at maturity on the instrument will be treated as equal to the instrument's inflation-adjusted principal amount for the day the holder acquires the instrument. Any premium or market discount will be taken into account over the remaining term of the debt instrument by making the same assumption.

STRIPS

A Treasury Inflation-Protection Security will be eligible upon issuance 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-Protection Security may be transferred as separate instruments (stripped bonds and coupons). In general, § 1286 treats the holder of a stripped bond (or coupon) as if the holder purchased a newly issued debt instrument that has OID. The regulations will provide that the holder of a component of a Treasury Inflation-Protection Security that is stripped under the Treasury STRIPS program must use the discount bond method to account for the OID on the component.

REOPENINGS

The regulations will provide that a reopening of Treasury Inflation-Protection Securities will be a qualified reopening for purposes of § 1.1275-2(d)(2), provided the reopening occurs not

more than one year after the original securities were first issued to the public.

EFFECTIVE DATE

The regulations will apply to debt instruments issued on or after the date the regulations are published in the Federal Register.

REQUEST FOR COMMENTS

The IRS and the Department of the Treasury request comments on the rules described in this notice. Comments should be submitted in writing on or before October 28, 1996 to: CC:DOM:CORP:R (Notice 96-51), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments (1) may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 96-51), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, DC, or (2) may be submitted electronically via the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. All comments will be available for public inspection and copying.

CONTACT PERSONS

For further information regarding this notice, contact Jeffrey W. Maddrey on (202) 622-4443 or William E. Blanchard on (202) 622-3950 (not toll-free numbers).