MEMO# 8558

January 16, 1997

TEMPORARY REGULATIONS ON INFLATION-INDEXED BONDS

1 The first offering of these securities, which provide an inflation-adjusted coupon payment and an inflation-adjusted principal amount, is scheduled for January 29, 1997. To illustrate the inflation adjustments, assume that an investor purchased a $1,000 bond with a 3% real rate of return coupon (payable 1.5% semi-annually). If inflation over the first six months were 1%, the principal amount of the bond would be adjusted to $1,010 ($1,000 times 1.01) and the first semi-annual interest payment would be $15.15 ($1,010 times 1.5%). 2 See Institute Memorandum to Tax Members No. 44-96, Pension Members No. 49-96, Institutional Funds Committee No. 20-96 and Money Market Funds Ad Hoc Committee No. 11-96, dated September 26, 1996. 3 An index for measuring inflation and deflation qualifies as a reference index if (1) the value of the index is reset once a month to the value of a single "qualified inflation index," (2) the reset occurs on the same day of each month and (3) the value of the index for any date between reset dates is determined through straight-line interpolation. 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. 4 Excluded from the rules are certain debt instruments, such as those issued by qualified state tuition programs. 5 A qualified inflation index is a general price or wage index updated and published at least monthly by an agency of the US Government. January 16, 1997 TO: INSTITUTIONAL FUNDS ADVISORY COMMITTEE No. 1-97 MONEY MARKET FUNDS ADVISORY COMMITTEE No. 2-97 PENSION MEMBERS No. 3-97 TAX MEMBERS No. 1-97 RE: TEMPORARY REGULATIONS ON INFLATION-INDEXED BONDS

____ The Treasury Department has issued the attached regulations (Temp. Treas. Reg. section 1.1275-7T) regarding the tax treatment of "inflation-indexed debt instruments" such as the recently-announced Treasury Inflation-Indexed Securities.1 In general, the regulations follow rules announced last fall2 by taxing currently as interest income an instrument's coupon payments (including the inflation component) and all inflation adjustments to principal. An inflation-indexed debt instrument is a debt instrument that is (1) issued for cash, (2) indexed for inflation and deflation using a formula based upon a "reference index"3 and (3) not otherwise a contingent payment debt instrument.4 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 "qualified inflation index"5 over the term of the instrument. Specifically, the amount of each payment must equal the product of (1) the amount that would be payable 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 income from an inflation-indexed debt instrument is taxed under either the coupon bond method or the discount bond method.

With respect to Treasury Inflation-Indexed Securities, the coupon bond method will apply if the instruments are not stripped, while the discount bond method will apply to stripped instruments. Coupon Bond Method The coupon bond method applies to an inflation-indexed debt instrument (1) that is issued at par (or at a de minimis difference from par), and (2) in which all of the stated interest is treated as qualified stated interest (because it is payable in cash or constructively received at least annually at a single fixed rate, adjusted for inflation/deflation). 6 The inflation adjusted principal equals (1) 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 (2) 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. 7 A holder's adjusted basis in an inflation-indexed debt instrument generally is determined under the OID basis adjustment rules of Treas. Reg. section 1.1272-1(g). However, a holder's adjusted basis is decreased by the amount of any deflation adjustment (discussed below) that the holder either takes into account to reduce the amount of interest otherwise includable in income or treats as an ordinary loss with respect to the instrument during the taxable year. The basis adjustment occurs when the deflation adjustment is taken into account. 8 As discussed in footnote 7, the adjusted basis of an inflation-indexed instrument is reduced for deflation. 9 A payment is not a guaranteed minimum payment unless the qualified inflation index used to determine the reference index is either the Consumer Price Index for Urban Consumers (CPI-U) or an index designated by the Internal Revenue Service for this purpose. Investors are taxed on the stated interest, under the coupon bond method, based upon their regular method of accounting. Any increase in the inflation adjusted principal amount6 is treated as original issue discount ("OID") for the period in which the increase occurs.7 Any decrease in the inflation adjusted principal amount is taken into account using special rules discussed below. Discount Bond Method The discount bond method applies to all inflation-indexed debt instruments that do not qualify for the coupon bond method. In a change from the IRS Notice issued last fall, the regulations provide that no interest payment on an inflation-indexed debt instrument subject to the discount bond method is qualified stated interest. The OID allocable to an accrual period is calculated using the following steps. First, yield to maturity is determined as if no inflation/deflation occurs over the term of the instrument. Second, the length of the accrual period (no more than one month long) for allocating OID is determined. Third, the percentage change in the value of the reference index during the accrual period is determined by comparing the beginning and ending values for the index. Fourth, the OID allocation is determined using a formula that takes into account both the yield on the debt instrument and the percentage change in the value of the reference index. Finally, a ratable portion of the OID is allocated to each day in the accrual period. Treatment of Deflation Adjustments The temporary regulations treat deflation adjustments in a manner generally consistent with the treatment of net negative adjustments on contingent payment debt instruments.8 Specifically, a deflation adjustment for a taxable year first reduces the amount of interest otherwise includable in income with respect to the debt instrument for the taxable year. If the deflation adjustment exceeds the amount of income for the year, the excess is treated as an ordinary loss to the extent that the gross amount previously included in income on the bond exceeds the gross amount (if any) previously treated by the taxpayer as a deflation adjustment ordinary loss. Any remaining excess deflation adjustment is carried forward to offset interest income in subsequent years. Minimum Guarantee Payment Treasury Inflation-Indexed Securities will include a minimum guarantee payment, which is an additional payment made at maturity equal to no more than the amount by which the instrument's stated principal amount exceeds its inflation-adjusted principal amount (adjusted down for net deflation over the term of the instrument).9 Under both the coupon bond method and the discount bond method, the minimum guarantee payment is taken into income as interest when the payment is made. Treatment of Subsequent Holders Subsequent holders of inflation-indexed debt instruments will determine premium or discount by treating the amount payable at maturity 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. Deadline for Comments on Regulations The Treasury Department’s deadline for filing comments on the regulations is April 7, 1997. Requests to testify at an April 30 hearing on the regulations must be filed, with an outline of topics to be covered, by April 9, 1997. Please contact the undersigned -- at 202/326-5832 -- by March 10 if you have any suggestions for an Institute submission. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment (in .pdf format) Note: Not all recipients of this memo will receive an attachment. If you wish to obtain a copy of the attachment referred to in this memo, please call the Institute’s Information Resource Center at (202)326-8304, and ask for this memo’s attachment number: 8558.
