INVESTMENT COMPANY INSTITUTE

MEMO# 8269

September 26, 1996

TREASURY DEPARTMENT ANNOUNCES STRUCTURE AND TAX TREATMENT OF INFLATION-PROTECTION SECURITIES

1 See Institute Memoranda to Institutional Funds Committee No. 8-96 and Money Market Funds Ad Hoc Committee No. 7-96, dated May 28, 1996; and to Tax Committee No. 19-96 and Pension Committee No. 21-96, dated June 3, 1996. 2 See Institute Memorandum to Institutional Funds Committee No. 12-96, Money Market Funds Ad Hoc Committee No. 9-96, Pension Committee No. 31-96 and Tax Committee No. 24-96, dated July 8, 1996. September 26, 1996 TO: TAX MEMBERS No. 44-96 PENSION MEMBERS No. 49-96 INSTITUTIONAL FUNDS COMMITTEE No. 20-96 MONEY MARKET FUNDS AD HOC COMMITTEE No. 11-96 RE: TREASURY DEPARTMENT ANNOUNCES STRUCTURE AND TAX TREATMENT OF INFLATION-PROTECTION SECURITIES ____ We are pleased to inform you that the Treasury Department has finalized its plans1 to issue Treasury obligations providing "protection" against inflation. The first "inflation- protection securities" will be ten-year notes issued quarterly, beginning on January 15, 1997, with a minimum denomination of $1,000. The Treasury Department’s announcement indicates that, as urged by the Institute,2 other maturities will be added within a year. General Structure The inflation-protection securities will be structured similarly to Canada’s Real Return Bonds. Under the inflation-protection securities’ structure, the principal amount will be adjusted for inflation (payable at maturity) and the semi-annual interest payments will equal a fixed percentage of the inflation- adjusted principal amount. For example, if an investor purchased a $1,000 bond with a 3% real rate of return coupon (payable 1.5% semi-annually), and inflation over the first six months were 1%, the mid-year value of the bond would be $1,010 and the first semi-annual interest payment would be $15.15 ($1,010 times 1.5%). If inflation accelerated during the second half of the year, so that it reached 3% for the full year, the end-of-year value of the bond would be $1,030 and the second semi-annual interest payment would be $15.45 ($1,030 times 1.5%). To permit holders such as investment companies to know each day the inflation-adjusted principal amount and the appropriate income accruals, inflation adjustments will be based upon Consumer Price Index for Urban Consumers ("CPI-U") data that is approximately three months old. Specifically, the "reference CPI" for the first day of any calendar month (e.g., January 1) would be the CPI-U for the first day of the third preceding month (e.g., October 1) as reported during the next month (e.g., November) and the reference CPI for any other day of the month would be calculated by linear interpolation. Thus, the appropriate inflation adjustments for each day in December would be known before the end of November. Also of interest to investment companies, the securities will be eligible for coupon stripping under the Treasury "STRIPS" program as of the first issue date. Tax Considerations A

separate IRS announcement (Notice 96-51) describes in detail the tax consequences of "inflation-indexed debt instruments," whether issued by Treasury or other entities. Under regulations to be promulgated before January 15, 1997, both the real rate of return coupon and all inflation adjustments to principal will be subject to current taxation as interest income. Taxpayers will be required, as described below, to use either the "coupon bond method" or the "discount bond method" to account for qualified stated interest and original issue discount ("OID") on the instrument. Special rules will apply to deflationary periods to reduce taxable income, create current ordinary deductions or generate carryforwards of "excess" deflation adjustments (depending on the deflation rate, the coupon rate and prior accruals). The coupon bond method will apply to Treasury inflation-protection securities that are not stripped into principal and interest components. Under 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. Holders of a stripped bond or coupon interest in a Treasury inflation-protection security will be treated by section 1286 as purchasing newly issued debt instruments that have OID. Under the regulations, holders of stripped Treasury inflation-protection securities will be required to account for OID using the discount bond method. 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. The Treasury Department has requested that all comments on the rules described in this notice be submitted on or before October 28, 1996. If you have any comments on these tax rules that you would like the Institute to submit, please contact the undersigned at (202) 326-5832 by October 14. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment 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: 8269.
