

**MEMO# 7914**

June 3, 1996

## **TREASURY PROPOSAL TO ISSUE INFLATION-INDEXED SECURITIES**

June 3, 1996 TO: TAX COMMITTEE No. 19-96 PENSION COMMITTEE No. 21-96 RE: TREASURY PROPOSAL TO ISSUE INFLATION-INDEXED SECURITIES

The Treasury Department has requested comments on a new type of Treasury obligation, an "inflation-protection" security, that Treasury intends to issue as a multi-year experiment. Treasury envisions that these securities, which would be issued with a minimum denomination of \$1,000, could be purchased either directly (from the Treasury Department or through brokers) or indirectly (through pooled investment vehicles such as regulated investment companies ("RICs")). Treasury presently is considering the following three structures for the securities, which are described in the attached materials. Under the first, or "Canadian," structure, the bond would make semiannual interest payments equal to a fixed percentage of an inflation-adjusted principal amount. At maturity, the bond would pay the inflation-adjusted principal amount. To illustrate this structure, assume an inflation-protection bond issued for \$1,000 that pays 4 percent interest (or \$40 in Year 1). Further assume that inflation was 3 percent during Year 1. In this example, the bonds interest payment in the second year would be 4 percent of \$1,030 (\$1,000 purchase price plus a 3 percent inflation adjustment to principal) or \$41.20. At maturity, the investor would receive the inflation-adjusted principal amount. The first "alternative" structure would be a zero-coupon inflation-protection bond that made only one payment of interest and principal, both adjusted for inflation, at maturity. The second "alternative" under consideration would make periodic payments of interest and principal. Each payment would have the same inflation-adjusted value, though the portion of each payment attributable to interest and principal would change. The tax treatment of inflation-protection securities is mentioned briefly in Treasurys "Questions and Answers" memorandum. The explanation indicates that, for a security structured similarly to a Canadian inflation-indexed bond, both principal appreciation and accrued/paid interest would be included currently in taxable income. The explanation provides that other tax details would be announced before the first issue. RICs holding inflation-protection bonds could be faced with cash-flow issues similar to those created by zero coupon bonds, to the extent that inflation-protection bonds were generating taxable income (e.g., principal appreciation) that was not being distributed currently to bond holders.

- 2 - Treasury has requested that comments on design details, possible terms and conditions of the new securities and other issues be submitted by June 19, 1996. Non-tax-related comments should be submitted to Alex Gavis, an attorney in the Institutes Securities and Financial Regulation Department, at 202/326-5923 by June 7, 1996. Any tax-related comments should be directed to the undersigned at 202/326-5832 by June 11, the date of the next Tax and Pension Committee meetings. We will keep you

informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment

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