MEMO# 11288

October 1, 1999

IRS ISSUES FINAL REGULATIONS ON INFLATION-INDEXED BONDS

1 See Institute Memorandum to Tax Members No. 1-97, Pension Members No. 3-97, Money Market Funds Advisory Committee No. 2-97 and Institutional Funds Advisory Committee No. 1-97, dated January 16, 1997. 2 The regulations do not apply to certain debt instruments, such as those issued by qualified state tuition programs. 3 In particular, income from an inflation-indexed debt instrument is taxed using the "coupon bond method" or the "discount bond method." Under the coupon bond method, for example, investors are taxed on stated interest based upon their regular method of accounting. Any increase in the inflation-adjusted principal amount is treated as original issue discount ("OID") for the period in which the increase occurs. [11288] October 1, 1999 TO: MONEY MARKET FUNDS ADVISORY COMMITTEE No. 16-99 PENSION MEMBERS No. 36-99 TAX MEMBERS No. 32-99 RE: IRS ISSUES FINAL REGULATIONS ON INFLATION-INDEXED BONDS ____ The Treasury Department has issued the attached final regulations (Treas. Reg. section 1.1275-7) regarding the tax treatment of "inflation-indexed debt instruments" such as Treasury Inflation-Indexed Securities. The final regulations replace and are identical to the temporary regulations issued on January 6, 1997.1 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" and (3) not otherwise a contingent payment debt instrument.2 In general, the regulations tax currently as interest income an instrument's coupon payments (including the inflation component) and all inflation adjustments to principal.3 To illustrate, assume that an investor purchased a $1,000 bond with a 3% real rate of return coupon (payable 1.5% semiannually). 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%). The regulations would treat both the $15.15 semi-annual interest payment and $10 inflation adjustment to principal as currently-taxable interest income. 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 discount will be taken into account over the remaining term of the debt instrument by making the same assumption. Deanna J. Flores Assistant Counsel Attachment Note: Not all recipients receive the attachment. To obtain a copy of the attachment referred to in this Memo, please call the ICI Library at (202) 326-8304, and ask for attachment number 11288. ICI Members may retrieve this Memo and its attachment from ICINet (http://members.ici.org).