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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9561]

RIN 1545-BK46

Treasury Inflation-Protected Securities Issued at a Premium

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance on the tax treatment of Treasury Inflation-Protected Securities issued with more than a de minimis amount of premium. The text of these temporary regulations also serves as the text of the proposed regulations (REG-130777-11) set forth in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Applicability Date: For the date of applicability, see §1.1275-7T(k).

FOR FURTHER INFORMATION CONTACT: William E. Blanchard, (202) 622-3950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Treasury Inflation-Protected Securities (TIPS) are securities issued by the Department of the Treasury. The principal amount of a TIPS is adjusted for any

inflation or deflation that occurs over the term of the security. The rules for the taxation of inflation-indexed debt instruments, including TIPS, are contained in §1.1275-7 of the Income Tax Regulations. See also §1.171-3(b) (rules for inflation-indexed debt instruments with bond premium).

The coupon bond method described in §1.1275-7(d) has applied to TIPS rather than the more complex discount bond method described in §1.1275-7(e). Under §1.1275-7(d)(2)(i), however, the coupon bond method is not available with respect to inflation-indexed debt instruments that are issued with more than a de minimis amount of premium (that is, an amount greater than .0025 times the stated principal amount of the security times the number of complete years to the security's maturity).

In Notice 2011-21 (2011-19 IRB 761), to provide a more uniform method for the federal income taxation of TIPS, the Department of the Treasury and the Internal Revenue Service announced that regulations would be issued to provide that taxpayers must use the coupon bond method described in §1.1275-7(d) for TIPS issued with more than a de minimis amount of premium. As a result, the discount bond method described in §1.1275-7(e) would not apply to TIPS issued with more than a de minimis amount of premium. Notice 2011-21 provided that the regulations would be effective for TIPS issued on or after April 8, 2011.

Explanation of Provisions

The temporary regulations in this document contain the rules described in Notice 2011-21. Under the temporary regulations, a taxpayer must use the coupon bond method described in §1.1275-7(d) for a TIPS that is issued with

more than a de minimis amount of premium. The temporary regulations contain an example of how to apply the coupon bond method to a TIPS issued with more than a de minimis amount of premium. As stated in Notice 2011-21, the temporary regulations apply to TIPS issued on or after April 8, 2011. See § 601.601(d)(2)(ii)(b).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is William E. Blanchard, Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1275-7T also issued under 26 U.S.C. 1275(d). * * *

Par. 2. Section 1.1275-7T is added to read as follows:

§1.1275-7T Inflation-indexed debt instruments (temporary).

(a) through (h) [Reserved]. For further guidance, see §1.1275-7(a) through (h).

(i) [Reserved]

(j) Treasury Inflation-Protected Securities issued with more than a de minimis amount of premium--(1) Coupon bond method. Notwithstanding §1.1275-7(d)(2)(i), the coupon bond method described in §1.1275-7(d) applies to Treasury Inflation-Protected Securities (TIPS) issued with more than a de minimis amount of premium. For this purpose, the de minimis amount is determined using the principles of §1.1273-1(d).

(2) Example. The following example illustrates the application of the bond premium rules to a TIPS issued with bond premium:

Example. (i) Facts. X, a calendar year taxpayer, purchases at original issuance TIPS with a stated principal amount of \$100,000 and a stated interest rate of .125 percent, compounded semiannually. For purposes of this example, assume that the TIPS are issued in Year 1 on January 1, stated interest is payable on June 30 and December 31 of each year, and that the TIPS mature on December 31, Year 5. X pays \$102,000 for the TIPS, which is the issue price for the TIPS as determined under §1.1275-2(d)(1). Assume that the inflation-adjusted principal amount for the first coupon in Year 1 is \$101,225 (resulting in

an interest payment of \$63.27) and for the second coupon in Year 1 is \$102,500 (resulting in an interest payment of \$64.06). X elects to amortize bond premium under §1.171-4. (For simplicity, contrary to actual practice, the TIPS in this example were issued on the date with respect to which the calculation of the first coupon began.)

(ii) Bond premium. The stated interest on the TIPS is qualified stated interest under §1.1273-1(c). X acquired the TIPS with bond premium of \$2,000 (basis of \$102,000 minus the TIPS' stated principal amount of \$100,000). See §§1.171-1(d), 1.171-3(b), and 1.1275-7(f)(3). The \$2,000 is more than the de minimis amount of premium for the TIPS of \$1,250 (.0025 times the stated principal amount of the TIPS (\$100,000) times the number of complete years to the TIPS' maturity (5 years)). Under paragraph (j)(1) of this section, X must use the coupon bond method to determine X's income from the TIPS.

(iii) Allocation of bond premium. Under §1.171-3(b), the bond premium of \$2,000 is allocable to each semiannual accrual period by assuming that there will be no inflation or deflation over the term of the TIPS. Moreover, for purposes of §1.171-2, the yield of the securities is determined by assuming that there will be no inflation or deflation over their term. Based on this assumption, for purposes of section 171, the TIPS provide for semiannual interest payments of \$62.50 and a \$100,000 payment at maturity. As a result, the yield of the securities for purposes of section 171 is -0.2720 percent, compounded semiannually. Under §1.171-2, the bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period (\$62.50 for each accrual period) over the product of the taxpayer's adjusted acquisition price at the beginning of the accrual period (determined without regard to any inflation or deflation) and the taxpayer's yield. Therefore, the \$2,000 of bond premium is allocable to each semiannual accrual period in Year 1 as follows: \$201.22 to the accrual period ending on June 30, Year 1 (the excess of the stated interest of \$62.50 over $(\$102,000 \times -0.002720/2)$); and \$200.95 to the accrual period ending on December 31, Year 1 (the excess of the stated interest of \$62.50 over $(\$101,798.78 \times -0.002720/2)$). The adjusted acquisition price at the beginning of the accrual period ending on December 31, Year 1 is \$101,798.78 (the adjusted acquisition price of \$102,000 at the beginning of the accrual period ending on June 30, Year 1 reduced by the \$201.22 of premium allocable to that accrual period).

(iv) Income determined by applying the coupon bond method and the bond premium rules. Under §1.1275-7(d)(4), the application of the coupon bond method to the TIPS results in a positive inflation adjustment in Year 1 of \$2,500, which is includible in X's income for Year 1. However, because X acquired the TIPS at a premium and elected to amortize the premium, the premium allocable to Year 1 will offset the income on the TIPS as follows: The premium allocable to the first accrual period of \$201.22 first offsets the interest payable for that period of \$63.27. The remaining \$137.95 of premium is treated as a deflation

adjustment that offsets the positive inflation adjustment. See §1.171-3(b). The premium allocable to the second accrual period of \$200.95 first offsets the interest payable for that period of \$64.06. The remaining \$136.89 of premium is treated as a deflation adjustment that further offsets the positive inflation adjustment. As a result, X does not include in income any of the stated interest received in Year 1 and includes in Year 1 income only \$2,225.16 of the positive inflation adjustment for Year 1 (\$2,500 - \$137.94 - \$136.89).

(k) Effective/applicability date. Notwithstanding §1.1275-7(h), this section applies to Treasury Inflation-Protected Securities issued on or after April 8, 2011.

(l) Expiration date. The applicability of this section expires on or before December 2, 2014.

Steven T. Miller
Deputy Commissioner for Services and Enforcement.

Approved: November 21, 2011

Emily S. McMahon
Acting Assistant Secretary of the Treasury (Tax Policy).

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