REPORT #886

TAX SECTION

New York State Bar Association

Report on Proposed Regulations Relating to Amortizable Bond Premium and Bond Issuance Premium

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TAX SECTION

New York State Bar Association

October 15, 1996

Hon. Donald C. Lubick,
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson,
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Report on Proposed Bond Premium and Bond Issuance Premium Regulations

Dear Secretary Lubick and
Commissioner Richardson:

I am pleased to submit the enclosed report addressing the proposed bond premium and bond issuance premium regulations (the “Proposed Regulations”). The principal authors of the report were Deborah L. Paul and Robert H. Scarborough, Co-Chairs of our Committee on Financial Instruments.

As discussed in the report, we believe that the Proposed Regulations are well-drafted and appropriately conform the treatment of bond premium and bond issuance premium to the treatment of original issue discount, except where the statute requires otherwise. The departures from consistency with the original issue discount rules in the case of convertible bonds and callable bonds produce anomalous results, however. As discussed in the report, we believe that:

1. The Proposed Regulations' requirement that holders and issuers of premium convertible bonds bifurcate basis and issue price, respectively, for amortization purposes is economically appropriate. We therefore support the approach, but note that it does create an undesirable inconsistency between the treatment of premium convertible bonds, on the one hand, and par and discount convertible bonds, on the other hand. We therefore also support consideration of Regulations under Sections 1272(a)(7) and 1286 that would conform the treatment of secondary holders of discount convertible bonds to the treatment of holders of premium convertible bonds.

2. The Department of the Treasury should consider seeking a technical amendment to Section 171 that would replace that Section’s formal and automatic rules relating to callable premium bonds with a more economic approach that takes into account the likelihood that a call will occur. Under current law, holders may already elect such an economic approach.

3. The Proposed Regulations reasonably require sinking funds to be disregarded by holders and issuers for practical reasons, but such treatment is inconsistent with likely issuer behavior in the case of premium bonds.

4. Holders should arguably be permitted to deduct, and issuers required to include, bond premium for an accrual period that exceeds QSI for the period.

Please do not hesitate to contact me if we can be of any further assistance in finalizing the Proposed Regulations.

Respectfully submitted,

Richard L. Reinhold
Chair

Encl.

Tax Report #886

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON FINANCIAL INSTRUMENTS

Report on Proposed Regulations Relating to Amortizable Bond Premium and Bond Issuance Premium

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON FINANCIAL INSTRUMENTS

Report on Proposed Regulations Relating to Amortizable Bond Premium and Bond Issuance Premium [1/]

On June 27, 1996, the Department of the Treasury promulgated proposed regulations (the “Proposed Regulations”) under Sections 61, 163, 171 and 1016 relating to the amortization of bond premium and bond issuance premium by holders and issuers, respectively. In general, Section 171 allows holders of bonds to amortize “bond premium”, which is the excess of basis over the amount payable at maturity, as an offset to interest income. Under current Treasury Regulation Section 1.61-12(c), issuers include “bond issuance premium”, which is the excess of issue price over the amount payable at maturity, in income.

In general, we believe that bond premium and bond issuance premium should be treated in a manner that is consistent with the original issue discount (“OID”) rules. Bond premium and bond issuance premium arise because some stated interest on a bond is treated as qualified stated interest (“QSI”), rather than included in the bond’s stated redemption price at maturity.

The distinction between interest that is treated as QSI and interest that is included in stated redemption price at maturity is, in many cases, economically insignificant or elective. Interest is treated as QSI only if it is unconditionally payable in cash or property at least annually.

[1/] The principal authors of this report are Deborah L. Paul and Robert H. Scarborough. Substantial contributions were made by David P. Hariton. Helpful comments were received from Stephen B. Land, Richard L. Reinhold, Michael L. Schler and Ronald E. Whitney.

Interest that accrues and compounds annually, but that is payable less frequently, is not treated as QSI and is included in OID Thus, a slight change in the terms of a bond may in some cases convert QSI into OID without significantly affecting the bond's economics.[2/] In addition, Treasury Regulation Section 1.1272-3 expressly permits holders to elect to treat all interest on a taxable debt instrument as OID. Finally, QSI on a bond can effectively be converted into OID by "stripping" the bond. The stripped bond and stripped coupon are each treated as a separate bond with OID under Section 1286. Because the distinction between interest that is treated as QSI and interest that is included in OID is formalistic, and because treatment of QSI as OID is elective, the treatment of issuers and holders should not depend on whether stated interest is QSI or OID. Thus, the bond premium and bond issuance premium rules should reach results that are consistent with the OID rules. Indeed, failure to reach consistent results could result in a trap for the unwary.

In our view, the Proposed Regulations are well-drafted and generally do conform the treatment of premium to the treatment of OID, except where Section 171 expressly requires different treatment. The departures from consistency with the OID rules in the case of convertible bonds and callable bonds produce anomalous results, however. As discussed below, we believe that:

1. The Proposed Regulations' requirement that holders and issuers of premium convertible bonds bifurcate basis and issue price, respectively, for amortization purposes is economically appropriate. We therefore support the approach, but note that it does create an undesirable inconsistency

[2/] Such a change may make the bond more difficult to market, however, since potential buyers may be more familiar with, or otherwise favor, instruments bearing QSI.

between the treatment of premium convertible bonds, on the one hand, and par and discount convertible bonds, on the other hand. We therefore also support consideration of Regulations under Sections 1272(a)(7) and 1286 that would conform the treatment of secondary holders of discount convertible bonds to the treatment of holders of premium convertible bonds.

2. The Department of the Treasury should consider seeking a technical amendment to Section 171 that would replace that Section's formal and automatic rules relating to callable premium bonds with a more economic approach that takes into account the likelihood that a call will occur. Under current law, holders may already elect such an economic approach.

3. The Proposed Regulations reasonably require sinking funds to be disregarded by holders and issuers for practical reasons, but such treatment is inconsistent with likely issuer behavior in the case of premium bonds.

4. Holders should arguably be permitted to deduct, and issuers required to include, bond premium for an accrual period that exceeds QSI for the period Background

I. Background

A. Holders

Under Section 171(e), a holder of a taxable bond may elect to allocate amortizable bond premium among interest payments and apply the amounts so allocated as offsets to interest income. See also Section 171(a)(1)(deduction for amortizable bond premium with respect to a taxable bond for the taxable year). A holder of a tax-exempt bond is required to amortize bond premium, resulting in a reduction in the holder's basis in the bond, but the holder may not deduct such premium. Section 171(a)(2); Section 1016(a)(5).

The total amount of amortizable bond premium is generally determined based on the holder's basis in the bond for determining loss and the amount payable on maturity. Section 171(b). If, however, in the case of a taxable bond, a smaller amortizable bond premium attributable to the period of an earlier call date would result, then the amount payable on such earlier call date is used, rather than the amount payable on maturity. Section 171(b)(1)(B)(ii). In the case of a callable tax-exempt bond, a holder uniformly amortizes based on the amount payable on the earlier call date. Section 171(b)(1)(B)(I); Rev. Rul. 60-17, 1960-1 C.B. 124. Bond premium may not reflect any amount attributable to the conversion feature of a convertible bond. Section 171(b)(1), flush language. Amortizable bond premium is allocated to a taxable year based on the taxpayer's yield to maturity. Section 171(b)(3)(A).

The Proposed Regulations allow holders to allocate to an accrual period an amount of amortizable bond premium equal to the excess of the QSI for the accrual period over the product of the holder's "adjusted acquisition price" at the beginning of the period and the holder's yield. Prop. Treas. Reg. Sec. 1.171-2(a)(3). The holder's adjusted acquisition price is the holder's basis adjusted to reflect previously amortized bond premium, as well as payments under the bond other than QSI. Prop. Treas. Reg. Sec. 1.171-2(b). In the event that bond premium allocable to an accrual period exceeds QSI for the period, such excess is carried forward. Prop. Treas. Reg. Sec. 1.171-2(a)(4).

The Proposed Regulations contain several special rules for certain types of bonds. Bond premium on a variable rate debt instrument is determined by reference to the stated redemption price at maturity of an equivalent fixed rate debt instrument. Prop. Treas. Reg. Sec. 1.171-3(a). Bond premium for a bond that provides for alternative schedules of payments whose timing and amounts are known at the time of acquisition is determined based on the schedule, if any, that is significantly more likely than not to occur. Prop. Treas. Reg. Sec. 1.171-3(b)(2). In the case of a taxable bond that provides the issuer with a call right, bond premium is calculated by assuming that the issuer will maximize the holder's yield on the bond, a noneconomic assumption. Prop. Treas. Reg. Sec. 1.171-3(b)(2).

B. Issuers

Under current law, corporations that issue bonds with bond issuance premium are required to include such premium (other than any portion of such premium attributable to a conversion feature) in income ratably. Treas. Reg. Sec. 1.61-l2(c). According to the Joint Committee, Congress "anticipated that the regulations relating to the treatment of bond premium by the issuing corporation (Treas. Reg. sec. 1.61-12(c)(2)) will be conformed to require the use of the constant yield method." Jt. Comm, on Tax'n, Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation (JCS-ll-87)(1987). Straight line amortization of bond issuance premium accelerates deductions of issuers relative to a constant yield method of amortizing premium.

The Proposed Regulations change the treatment of issuers by requiring all issuers to allocate bond issuance premium among accrual periods using a constant yield method and offset QSI allocable to an accrual period with the bond issuance premium allocated to the period. Prop. Treas. Reg. Secs. 1.163- 13(a), -13(d). The aggregate amount of bond issuance premium is the excess of the issue price over the stated redemption price at maturity. Issue price, for that purpose, does not include an amount equal to the value of the conversion option under a convertible bond. Prop. Treas. Reg. Sec. 1.163-13(c). Bond issuance premium allocable to an accrual period is the excess of QSI for the period over the product of the adjusted issue price at the beginning of the period and the yield. Prop. Treas. Reg. Sec. 1.163-13(d)(3).

II. Convertible Bonds

We support the Proposed Regulations’ treatment of holders and issuers of convertible bonds purchased or issued at a premium. By requiring holders to reduce basis, and issuers to reduce issue price, by the value of the conversion right for purposes of Sections 171 and 163, respectively, the Proposed Regulations effectively conform the treatment of convertible bonds issued at a premium to the treatment of investment units. We believe that the approach of the Proposed Regulations is appropriate as an economic matter, because, in many cases, an issuer of convertible debt could instead issue a nonconvertible bond and an option to purchase issuer stock, in which case holders would not be entitled to amortize their basis in the option, and the issuer would not be required to reduce interest expense by the option premium. Moreover, the approach of the Proposed Regulations is consistent with the longstanding treatment of issuers of premium convertible bonds, under Treasury Regulation Section 1.61-l2(c), and holders of such bonds, under Section 171(b), flush language, and Treasury Regulation Section 1.171-2(c).

The approach of the Proposed Regulations does, however, create an undesirable inconsistency between the treatment of premium convertible bonds, on the one hand, and par and discount convertible bonds, on the other hand. Section 171(b) and the Proposed Regulations effectively require holders and issuers of premium convertible bonds to accrue interest at a rate equal to the yield on comparable nonconvertible bonds, while holders and issuers of par and discount convertible bonds accrue interest at a lower rate that reflects the value of the conversion feature. See Prop. Treas. Reg. Secs. 1.163-13(c), 1.171-1(e)(1)(iii).[3/] Suppose, for example, that the market rate of interest on an issuer's convertible debt is 6%, while the market rate for the issuer's nonconvertible debt is 10%. A convertible bond issued at par would give rise to inclusions for the holder, and deductions for the issuer, of 6%, the stated interest, notwithstanding that the instrument could be viewed as a combination of an original issue discount bond with a yield of 10% and an option. Because holders and issuers do not bifurcate a convertible bond purchased or issued at par to reflect the portion of the purchase price or issue price attributable to the conversion option, such holders and issuers accrue interest at a rate that is lower than the rate

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[3/] Cf. Section 249 (no deduction for bond repurchase premium to the extent attributable to conversion feature); Treas. Reg. Sec. 1.171-2(c)(bond premium calculated by reference to comparable nonconvertible bonds).

accrued for the use of funds under a nonconvertible bond.[4/]

The Proposed Regulations provide for a different result in the case of premium convertible bonds. For example, suppose that the issuer in the above example issued for $120 a convertible bond that provided for a $100 payment at maturity and stated interest of 10%, resulting in a 6% yield on the convertible bond. Suppose that the value of the conversion option is $20. Then, neither the holder nor the issuer would amortize premium. The holder would be required to include, and the issuer entitled to deduct, 10% per annum, which is the interest rate on the issuer's nonconvertible debt.

The approach of the statute and the Proposed Regulations creates undesirable tax incentives. Issuers, for example, would be well-advised to issue premium convertible bonds to tax-exempt or foreign holders in order to enjoy larger interest deductions than would be available if the issuer issued par or discount convertible bonds. Taxable holders will gravitate away from premium convertible bonds and investment units in favor of par or discount convertible bonds, with respect to which holders are entitled to recover their basis in the conversion option over the term of the bond. Unfortunately, the creation of tax incentives

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[4/] See Treas. Reg. Sec. 1.1273-2(j)(issue price of convertible debt instrument includes amount paid for conversion option). In addition, several cases have held that an issuer is not permitted to allocate a portion of the issue price of a convertible bond to the conversion right in order to increase the amount of its interest deductions. See Chock Full O'Nuts Corporation v. United States. 453 F.2d 300 (2d Cir. 1971); Honeywell Inc. v. Commissioner, 87 T.C. 624 (1986); AMF Inc. v. United States. 476 F.2d 1351 (Ct. Cl. 1973).

The treatment of convertible bonds is inconsistent with the treatment of contingent payment debt instruments under recently finalized Treasury Regulation Sec. 1.1275-4(b), which requires that interest on a contingent payment debt instrument be accrued at a yield equal to the yield on a comparable fixed payment debt instrument of the issuer.

in this area is inescapable as long as any convertible bonds are treated differently from nonconvertible bonds.

The inconsistent treatment of convertible bonds that exists under current law (and would continue under the Proposed Regulations) can be illustrated by the following matrix:

	Bonds with Premium	Bonds without Premium (i.e., bonds issued or acquired at par or at a discount and bonds without QSI)
Issuers and Holders Purchasing at Original Issue	I: current law effectively bifurcates; Proposed Regulations also effectively bifurcate	II: current law does not bifurcate; Proposed Regulations have no effect
Holders Purchasing in the Secondary Market	III: current law effectively bifurcates; Proposed Regulations also effectively bifurcate	IV: current law does not bifurcate; Proposed Regulations have no effect

In Cases I and III, current law effectively bifurcates convertible premium bonds both for issuers and for holders, whether or not purchasing at original issuance. Current Treasury Regulation Section 1.61-12(c) provides that an issuer is not required to include in income that portion of premium that is attributable to a conversion feature. Similarly, Section 171(b) does not permit a holder to amortize premium attributable to a conversion right.[5/]

[5/] Although Section 171(b) and the Proposed Regulations do not permit holders, and the Proposed Regulations do not require issuers, to amortize the value of a conversion right, the reduction in a holder's basis and in issue price reflecting a conversion right applies only for purposes of calculating bond premium and bond issuance premium, and will therefore not create market discount for a holder or OID for an issuer. See. Section 171(b); Prop. Treas. Reg. Secs. 1.163-13(c), 1.171-l(e), 1.171- 1(f) Example 2.

In contrast, in Cases II and IV, current law does not bifurcate par or discount debt, either for issuers or for holders. Judicial decisions, including Chock Full O'Nuts, supra, hold that an issuer cannot increase or create OID deductions by allocating a portion of the issue price of a convertible bond to the conversion feature.

Similarly, holders, whether or not purchasing at original issuance, are not required to allocate a portion of the purchase price of a convertible bond purchased at par or at a discount to the conversion right in determining their OID income inclusions. For example, under Section 1272(a)(7), a person acquiring a bond issued with OID at a price in excess of the instrument's adjusted issue price may amortize such excess (the "purchase allowance") in a manner similar to the deduction for bond premium allowed under Section 171. The purchase allowance rule contains no analogue to the Section 171(b) limitation on amortizing the portion of bond premium attributable to a conversion privilege. Thus, although the treatment of Cases II and IV is consistent under current law, the treatment of Cases I and III, on the one hand, and Cases II and IV, on the other hand, is inconsistent. This inconsistent treatment extends beyond bonds issued at a discount, by virtue of the bond stripping provisions of Section 1286. Under those rules, a bond may effectively be converted to a discount obligation by disposing of one or more interest payments not yet due, or by buying such an instrument. Accordingly, in Case IV, a secondary market purchaser can claim the cost of the conversion privilege as an offset to interest and OID income, although this would not be possible in the case of a bond acquired at a premium (Case III).

In theory, one approach to resolving those inconsistencies would be to require bifurcation of all convertible bonds, thereby changing the results in Cases II and IV. Such a change, although arguably correct economically, would be a dramatic departure from well-established law and could introduce substantial complexity, especially in the case of par convertible bonds bearing (under current law) only QSI. Alternatively, consideration might be given to conforming the treatment of all convertible bonds acquired at original issuance (Cases I and II), by not bifurcating them. There does not seem to be any policy justification for treating Cases I and II differently from one another. Under that approach, holders would be allowed, and issuers would be required, to amortize premium attributable to the conversion feature, except to the extent that such premium exceeds QSI otherwise accruing on the bond.[6/]

We do not support that approach, however, both because it would extend a noneconomic rule and would reverse well-established law, requiring amendment to Section 171(b). Assuming that the treatment of Case I is not changed, there is no argument for changing the treatment of Case III.

Another approach would be to conform the treatment of Case IV to Case III. Accordingly, we support consideration of Regulations under Section 1272(a)(7) and Section 1286 to require holders to allocate a portion of the purchase price of a convertible bond acquired in the secondary market to the conversion feature, thereby reducing the amount of acquisition premium and increasing the amount of OID reported.[7/] We recognize that those changes would introduce an inconsistency between Cases

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6/ Under that approach, it would be necessary to require carryforward, rather than current amortization, of bond premium on a convertible bond to the extent in excess of QSI accruing on the bond. Proposed Treasury Regulation Section 1.171-2(a)(4) so provides. Otherwise, taxpayers could use amortizations of deep in-the-money convertible bonds effectively to offset income from other investments.

7/ By analogy with the approach of Section 171(b), such allocation would in no case give rise to market discount.

II and IV that does not exist under current law. Such inconsistent tax treatment will, in some cases, appropriately reflect a difference in economic substance, however. The price of a convertible bond acquired in the secondary market may reflect an increase (which may be very substantial) in the value of the conversion right after original issuance. Amortization of that increased value is particularly difficult to justify.[8/]

III. Callable Bonds

A. Noneconomic Assumption Relating to Issuer Call

Section 171 and Proposed Treasury Regulation Section 1.171-3(b)(4) require holders of taxable bonds to make noneconomic assumptions relating to an issuer’s exercise of a call right. On the one hand, a holder must amortize premium over the life of the bond even if it is likely that the issuer will call the bond prior to maturity. Congress enacted that rule because it believed that holders were abusing a prior rule that allowed holders to amortize bond premium to an earlier call date. Holders were acquiring bonds that were callable within a short period of time (such as 30 days), immediately deducting the premium against ordinary income and then selling the bonds at a capital gain, even though the issuers were unlikely to call the bonds.[9/] Congress did not provide an exception from the new rule for cases where the issuer was likely to call the bond. Congress

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[8/] The problem of holders amortizing basis attributable to a deep in-the-money conversion right is less likely to arise in the case of holders purchasing at original issue. **See** Rev. Rul. 83-98, 1983-2 C.B. 40.

[9/] S. Rep. No. 1622, 83rd Cong., 2d Sess., H.R. 8300 (1954), and S. Rep. No. 1983, 85th Cong. 2d Sess., H.R. 8381 (1958).

apparently believed it sufficient to grant holders an ordinary deduction if and when the issuer called the bond.[10/]

On the other hand, a holder must amortize to an earlier issuer call date if doing so would result in amortization of a smaller amount of premium. For example, if a holder purchases for $120 a bond that is due to mature in five years for $100, but which is callable by the issuer for $120 at the end of three years, the holder may not amortize any bond premium over the first three years, even though it is unlikely that the issuer will pay the holder $120 at the end of three years, rather than $100 at the end of five years. Thus, a holder must presume exercise of an issuer's right to call a bond prior to maturity for an amount that is greater than the bond's stated redemption price at maturity, even though such exercise is unlikely, because it would increase the yield on the bond. That assumption is the precise opposite of the intuitively logical rule that prevails in the OID regulations, as well as under Section 305(c). Those regulations presume that the issuer will exercise its options in a manner that minimizes yield. Treas. Reg. Secs. 1.305-5(b)(3)(ii), 1.1272-1(c)(5).

The noneconomic issuer call assumption in the Proposed Regulations can effectively be avoided if the holder simply elects to treat all interest on a bond as OID under Treasury Regulation Section 1.127 2-3. In the case of such an election, interest would accrue on the bond under the general OID rules, and Section 171 would be irrelevant. The noneconomic issuer call assumption also would not apply if the bond is stripped. In that case, the holder of a stripped bond or stripped coupon would be subject to the economic call rules applicable to debt instruments with OID.

10/ /Id.

Furthermore, the issuer call assumption could potentially be avoided by structuring an instrument that provided for alternative payment schedules, rather than an issuer call, because instruments with alternative payment schedules are governed by more economic assumptions than callable instruments. See Prop. Treas. Reg. Sec. 1.171-3(b)(2). For example, suppose that an issuer was planning to issue for $120 a five-year $100 bond paying interest at 10% per annum, but the issuer wanted the right to call the bond for $120 at the end of three years. A holder of such a bond would not be entitled to amortize the $20 of bond premium, because Proposed Treasury Regulation Section 1.171-3(b)(4) would require the holder to presume that the issuer would exercise the call option. Properly advised, the issuer might instead provide that the bond would automatically be redeemed at the end of three years if, but only if, interest rates had fallen enough to cause the bond to trade significantly above the price for which the issuer could issue comparable debt. Assuming that it is significantly more likely than not that the bond would remain outstanding until maturity in five years, the three-year alternative payment schedule would be disregarded for purposes of determining bond premium. The holder would therefore be entitled to amortize $20 of bond premium. Thus, elimination of the issuer’s discretion to redeem early, in favor of a provision that would work in a manner consistent with the issuer’s likely behavior if the issuer did have discretion, would permit holders to begin amortizing the $20 of bond premium immediately.

The requirement in Section 171(b)(1)(B)(ii) that holders accrue over the period until maturity, unless accruing to an earlier call date would result in “smaller” amortizations for the pre-call period, is anachronistic. The OID regulations reflect a more economic approach to debt instruments subject to contingencies by assuming that an issuer will call a bond if the call would result in a lower yield. See Treas. Reg. Sec. 1.1272-1(c)(5). Consistent with our general view that the treatment of bonds issued at a premium should be consistent with the treatment of OID debt instruments, we recommend that the Department of the Treasury seek a technical amendment to Section 171 that would replace the formal and automatic rules relating to bonds subject to call with a statute that grants the Secretary regulatory authority to permit and require amortization of premium on callable bonds in a manner that clearly reflects income. The Secretary could then extend the “yield rule” of the OID regulations to premium amortization.

We assume that, notwithstanding the possible relevance of prevailing interest rates to an issuer’s decision whether to call an outstanding bond, the yield rule would be applied to secondary holders based on the terms of the bond, rather than by reference to prevailing interest rates. That approach would be consistent with the OID rules.[11/] If the yield rule is adopted, applicable regulations should clarify that point.

Regulations might include some exceptions from application of the yield rule to avoid any potential for abuse. For example, the yield rule might not be applied to a bond that is callable for only a limited period of time (for example, less than one year) after original issuance of the bond, since, as noted above, Congress has expressed concern about premium amortization arising from limited term call rights that are unlikely to be exercised. Likewise, Regulations might reserve for the Commissioner the discretion to depart from the yield rule in cases where the Commissioner can demonstrate, based on all the

[11/] Under the OID rules, the amount and timing of OID accruals are based on the issue price and the yield of the debt instrument, which are determined at the time the instrument is issued based on its terms. See Treas. Reg. Secs. 1.1272-1, 1.1273-1, 1.1273-2.

relevant facts and circumstances, that a call that reduces yield is unlikely to be exercised (for example, because of a strongly-sloped yield curve).

B. Sinking Funds

1. Taxable Bonds

Under the Proposed Regulations, for purposes of amortizing bond premium and bond issuance premium, holders and issuers disregard mandatory sinking fund provisions that meet reasonable commercial standards. Prop. Treas. Reg. Secs. 1.163-13(a), 1.171-3(b)(3). The OID regulations similarly disregard sinking funds. See Treas. Reg. Sec. 1.1272-1(c)(3)(ii). Sinking funds generally provide that a certain percentage of outstanding bonds will be repurchased by the issuer in the market or will be selected by lot and called for a price equal to their stated principal amount.

The sinking fund rule in the Proposed Regulations may be based in part on an assumption about issuer behavior that makes better sense in the case of bonds issued with OID than in the case of bonds subject to the premium rules. In the case of bonds issued at a discount from their stated principal amount, unless market interest rates decrease dramatically after issuance, the issuer will likely purchase bonds in the market at a discount from par rather than allowing the bonds to be called at par pursuant to the sinking fund provision. It is therefore reasonable to disregard the sinking fund in determining OID accruals. In the case of bonds issued or acquired at a premium above their stated principal amount, however, an issuer acting to minimize yield will allow the bonds to be called at par pursuant to the sinking fund, unless market interest rates have increased sufficiently so that the bonds are trading below par at the time that the sinking fund is triggered. The Proposed Regulations' approach of disregarding a sinking fund in the case of premium bonds is thus inconsistent with the issuer's expected behavior, absent a dramatic change in interest rates.

Although it thus appears economically appropriate for holders of premium bonds to take sinking funds into account, disregarding sinking funds appears consistent with Section 171. See Sections 171(b)(1)(B)(ii), 171(b)(3)(B). Moreover, it would be difficult as a practical matter for holders to take sinking fund provisions into account, since a particular holder does not know whether the holder's bonds will be called. A holder could be permitted to amortize to the call date the percentage of the premium that corresponds to the percentage of bonds in the issue that are expected to be called. We do not endorse that approach, however, because it would be impractical.

As to issuers, disregarding sinking funds effectively permits an issuer to accrue interest deductions based on the assumption that its bonds will not be called, when in fact some of them likely will be called at par pursuant to the sinking fund. An alternative approach would be for issuers to assume that the percentage of an issue of bonds subject to call under a sinking fund would be called if, at issuance, it is expected that the sinking fund call would reduce yield to maturity. For issuers, a pro rata approach is not as impractical as it is for holders. Asymmetry between the treatment of holders and issuers may, however, be undesirable.

2. Tax-Exempt Bonds

Under current law, holders of callable tax-exempt bonds always amortize premium to the call date, regardless whether doing so results in a greater or lesser amount of premium attributable to the period before the call date. See Section 171(b)(1)(B)(I); Rev. Rul. 60-17, 1960-1 C.B. 124. That rule disadvantages holders of tax-exempt bonds by requiring more rapid amortization of premium than would be the case if the call were disregarded.

Current law provides no special rules for sinking funds. Since there is no authority on point and all the bonds in an issue are potentially subject to call, a holder of a tax- exempt bond subject to a sinking fund might amortize premium on the entire bond to the date that bonds are subject to call, even though only a portion of the bonds in an issue will be called. Alternatively, such a holder might amortize only a portion of the premium equal to the percentage of the bonds in the issue that will be called.

Notwithstanding the implication in Section 171(b)(1)(B)(I) that a call date prior to maturity should always be used by holders of tax-exempt bonds, under the Proposed Regulations, a mandatory sinking fund would be disregarded by such holders.[12/] As discussed above, that approach is inconsistent with likely issuer behavior in the case of bonds purchased at a premium. The issuer of such a bond is likely to allow the sinking fund to operate, rather than repurchase its bonds in the market. That observation supports requiring holders of tax-exempt bonds to take sinking funds into account for purposes of amortization

12/ Prop. Treas. Reg. Sec. 1.171-3 (b)(3). The Proposed Regulations depart from the statute in the case of holders of tax-exempt bonds subject to an issuer's option to call. Such an issuer is presumed to exercise its call only if the call would reduce yield to maturity. Prop. Treas. Reg. Sec. 1.171-3(b)(4)(ii)(A).

of bond premium. Because only a fraction of the bonds in an issue will be called pursuant to a sinking fund, it would be unfair to holders to require that they amortize all premium on all bonds in an issue to the sinking fund call date. Instead, holders could be required to prorate. Proration would, however, be impractical. We therefore support the approach of the Proposed Regulations to disregard sinking funds.

C. Measurement of Bond Premium Deduction Upon Change in Circumstances

In the case of an issuer call right that was disregarded by the holder in determining the holder’s amortization schedule, but in fact is exercised, Proposed Treasury Regulation Section 1.171-3(b)(5)(ii) allows the holder to deduct as bond premium the excess, if any, of the adjusted acquisition price of the bond over the <u>greater</u> of the amount received on redemption and the “amount payable on maturity”. It appears that the “amount payable on maturity” limitation is designed to limit the bond premium deduction to an amount that is no greater than the amount of bond premium that the holder would have amortized if the bond had remained outstanding until maturity. If so, the “amount payable on maturity” concept should not be used, because it produces inappropriate results in the case of installment obligations. Instead, the bond premium deduction should equal the excess, if any, of the holder’s adjusted acquisition price over the greater of the amount received on redemption and <u>the amounts that would have been payable under the bond if no change in circumstances had occurred (other than QSI)</u>. Alternatively, and more simply, the bond premium deduction should equal the lesser of the unamortized bond premium and the excess, if any, of the holder’s adjusted acquisition price over the amount received on redemption.

IV. Other

A. Basis for Section 171 Purposes

Proposed Treasury Regulation Section 1.171-1(e) provides that, in general, a holder's basis in a bond for purposes of Section 171 is the holder's basis for determining loss. If, however, the bond is a convertible bond, the holder's basis in the bond, for Section 171 purposes, is reduced by an amount equal to the value of the conversion option. Further, if a bond is transferred basis property, the holder's basis in the bond, for Section 171 purposes, is the holder's basis for determining loss reduced by any amounts that the transferor could not have amortized because of a conversion feature. In the case of convertible bonds transferred by gift, those rules could result in an inappropriately low Section 171 basis for the donee.

> Example: Donor acquires a convertible bond (the "Convertible Bond") for $100 cash. The Convertible Bond provides for payment at maturity of $80 and annual fixed interest payments. At the time that Donor acquires the Convertible Bond, the fair market value of the conversion option is $5. The bond premium in Donor's hands is therefore $15 (equal to Donor's $100 basis for purposes of determining loss reduced by the $5 conversion premium and the $80 amount payable on the Convertible Bond other than QSI). Suppose that, one year after Donor's acquisition, the value of the Convertible Bond is $85, the value of the conversion option is zero, Donor has amortized $2 of bond premium and Donor transfers the Convertible Bond as a gift to Donee. At such time, Donor's basis in the Convertible Bond for purposes of determining gain or loss is $98. Under Section 1015, Donee's basis in the Convertible Bond for purposes of determining loss is $85, equal to the Convertible Bond's fair market value. Proposed Treasury Regulation Section 1.171-1(e.)(2) provides that Donee's basis for Section 171 purposes is $80, equal to Donee's $85 basis for loss purposes less the $5 conversion right value that Donor was not allowed to amortize. The bond premium is accordingly zero in Donee's hands, since Donee's Section 171 basis equals the $80 amount payable under the Convertible Bond other than QSI.

That result is anomalous. In that fact pattern, the $5 loss in value of the conversion option is taken into account under the fair market value limitation of Section 1015 and should not therefore result in a second reduction in Donee's Section 171 basis, as provided in Proposed Treasury Regulation Section 1.171-1(e)(2)(ii). If Donor had purchased only the bond portion of the Convertible Bond, Donor would have had an initial basis of $95 and bond premium of $15. If Donor had transferred such bond one year later when it was worth $85 and Donor's basis was $93 (reflecting amortization of $2 of premium), Donee would have acquired the bond with a basis for loss purposes and Section 171 purposes of $85. The bond would therefore have had bond premium in Donee's hands of $5. In the case of the Convertible Bond, Donee should therefore also be entitled to $5 of bond premium. In general, a donee's Section 171 basis in a convertible bond should equal the donee's basis for determining loss, reduced by amounts that the donor could not have amortized because of the conversion feature, except to the extent that the donee's basis for determining loss already reflects reductions attributable to such nonamortizable amounts.

B. Carryforward of Excess Premium

Proposed Treasury Regulation Sections 1.163-13(d)(4) and 1.171-2(a)(4) provide that if the amount of bond premium or bond issuance premium for an accrual period exceeds QSI for the period, the excess is carried forward to the next accrual period. It is not clear whether that result is consistent with the statute in the case of holders. Section 171 arguably permits holders to deduct from income such excess in the period to which it is properly allocable.

Specifically, Section 171 generally grants holders a deduction for amortizable bond premium for the relevant taxable year. Section 171(e), which was enacted in 1986 and amended in 1988, grants holders a reduction in any interest income to which such bond premium has been allocated in lieu of the deduction allowed under Section 171(a). Arguably, if a portion of the premium cannot be allocated to a particular item of interest income (because the item has already been reduced to zero), such portion should be allowed as a deduction under Section 171(a). The legislative history of Section 171 does not suggest that Congress intended Section 171(e) to preclude a deduction for bond premium in excess of interest allocable to an accrual period. Indeed, the 1988 revisions appear to have been intended merely to change the character of bond premium, presumably for the benefit of holders. See New York State Bar Association Tax Section, Report on Certain Issues Presented by Interest Strips in Securitization Transactions 40-41 (March 8, 1996).

As a practical matter, bond premium in excess of QSI for a period is likely to arise only in the case of a variable rate debt instrument (or in the case of the materialization of an unlikely alternative payment schedule which greatly reduces or eliminates QSI).[13/] We recognize that in the case of a contingent payment debt instrument governed by Treasury Regulation Section 1.1275-4, a “net negative adjustment” that exceeds interest otherwise accruing on the comparable noncontingent bond is carried forward to the subsequent accrual period. That rule is

[13/] If a contingent payment debt instrument does not qualify as a variable rate debt instrument, the bond issuance premium rules are supplanted by Treasury Regulation Section 1.1275-4. If interest on a fixed-rate debt instrument does not constitute QSI, it is added to the instrument's stated redemption price at maturity, thereby eliminating any corresponding bond issuance premium. A fixed-rate debt instrument promising QSI presumably will not be acquired at a premium that exceeds that interest, since such a premium would reduce the holder's yield to zero.

partly designed to prevent taxpayers from obtaining unjustified tax losses by overestimating the amount of early contingent interest payments. It is not needed, however, in the case of a variable rate debt instrument, which usually provides for interest based on a single interest formula but in any case contains adequate safeguards against the frontloading and backloading of interest.[14/]

[14/] The problem may be analogous to the treatment under the "snapshot approach" of Treasury Regulation Section 1.127 5-5 of a variable rate debt instrument which, for some reason, does not provide for QSI and which is acquired for an amount in excess of its adjusted issue price. -If a "downward adjustment" on the bond completely eliminates income otherwise accruing on the equivalent fixed-rate debt instrument, see Treas. Reg. Sec. 1.1275-5 (e)(3)(iv)), there is no authority permitting the taxpayer to deduct currently the residual premium properly allocable to that interest period.