Part III - Administrative, Procedural, and Miscellaneous

Treasury Inflation-Protected Securities Issued at a Premium

Notice 2011-21

This notice provides guidance on the tax treatment of Treasury Inflation-Protected Securities ("TIPS") issued at a premium. 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 TIPS (and other inflation-indexed debt instruments) are contained in §1.1275-7 of the Income Tax Regulations. See also §1.171-3(b) (rules for TIPS with bond premium). To date, 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 the existing regulations, 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. Section 1.1275-7(d)(2)(i). Due to recent financial conditions, however, the Department of the Treasury anticipates that TIPS may be issued at a premium that is more than a de minimis amount as determined under the principles of §1.1273-1(d) (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).

To provide a more uniform method for the federal income taxation of TIPS, the Internal Revenue Service and the Department of the Treasury plan to issue regulations that will provide that taxpayers must apply the coupon bond method described in §1.1275-7(d) with respect to TIPS issued with more than a de minimis amount of premium. As a result, the discount bond method described in §1.1275-7(e) will not apply to TIPS issued with more than a de minimis amount of premium. The regulations will be effective for TIPS issued on or after April 8, 2011.

EXAMPLE

The following example illustrates the application of the coupon bond method to TIPS issued at a premium on or after the effective date of the change to §1.1275-7 as described in this notice:

(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)). Although the TIPS were issued with more than a de minimis amount of bond premium, 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 x -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 x -0. 002720/2)).

(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 offsets the remaining 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).

DRAFTING INFORMATION

The principal author of this notice is William E. Blanchard of the Office of the Associate Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Mr. Blanchard at (202) 622-3950 (not a toll-free call).