

**(4) Cross reference**

For civil penalty for failure to meet requirements of this subsection, see section 6706.

**(d) Regulation authority**

The Secretary may prescribe regulations providing that where, by reason of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances, the tax treatment under this subpart (or section 163(e)) does not carry out the purposes of this subpart (or section 163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart (or section 163(e)).

(Added and amended Pub. L. 98-369, div. A, title I, §§41(a), 61(c)(2), July 18, 1984, 98 Stat. 540, 581; Pub. L. 99-514, title XVIII, §1804(f)(2)(A), Oct. 22, 1986, 100 Stat. 2805; Pub. L. 100-647, title I, §1006(u)(4), Nov. 10, 1988, 102 Stat. 3427; Pub. L. 101-508, title XI, §11325(a)(2), Nov. 5, 1990, 104 Stat. 1388-466; Pub. L. 106-554, §1(a)(7) [title III, §318(c)(1)], Dec. 21, 2000, 114 Stat. 2763, 2763A-645.)

**AMENDMENTS**

2000—Subsec. (a)(1)(B)(ii). Pub. L. 106-554, in introductory provisions, substituted “subchapter L (or by an entity described in section 501(c) and exempt from tax under section 501(a) which would be subject to tax under subchapter L were it not so exempt)” for “subchapter L”.

1990—Subsec. (a)(4), (5). Pub. L. 101-508 redesignated par. (5) as (4) and struck out former par. (4) which related to a special rule for determination of issue price in case of exchange of debt instruments in reorganization.

1988—Subsec. (a)(4)(B)(ii)(D). Pub. L. 100-647 substituted “subsection (a)(7)” for “subsection (a)(6)”.

1986—Subsec. (a)(4), (5). Pub. L. 99-514 redesignated par. (4), relating to treatment of obligations distributed to corporations, as (5), and substituted “by corporations” for “to corporations” in heading.

1984—Subsec. (a)(4). Pub. L. 98-369, §61(c)(2), added par. (4) relating to treatment of obligations distributed to corporations.

**EFFECTIVE DATE OF 2000 AMENDMENT**

Pub. L. 106-554, §1(a)(7) [title III, §318(c)(2)], Dec. 21, 2000, 114 Stat. 2763, 2763A-645, provided that: “The amendment made by this subsection [amending this section] shall take effect as if included in the amendments made by section 41 of the Tax Reform Act of 1984 [Pub. L. 98-369, div. A].”

**EFFECTIVE DATE OF 1990 AMENDMENT**

Amendment by Pub. L. 101-508 applicable, with certain exceptions, to debt instruments issued and stock transferred after Oct. 1, 1990, in satisfaction of any indebtedness, see section 11325(c) of Pub. L. 101-508, set out as a note under section 108 of this title.

**EFFECTIVE DATE OF 1988 AMENDMENT**

Amendment by Pub. L. 100-647 effective, except as otherwise provided, as if included in the provision of the Tax Reform Act of 1986, Pub. L. 99-514, to which such amendment relates, see section 1019(a) of Pub. L. 100-647, set out as a note under section 1 of this title.

**EFFECTIVE DATE OF 1986 AMENDMENT**

Amendment by Pub. L. 99-514 effective, except as otherwise provided, as if included in the provisions of the Tax Reform Act of 1984, Pub. L. 98-369, div. A, to which such amendment relates, see section 1881 of Pub. L. 99-514, set out as a note under section 48 of this title.

**EFFECTIVE DATE OF 1984 AMENDMENT**

Amendment by Pub. L. 98-369 applicable with respect to distributions declared Mar. 15, 1984, in taxable years

ending after that date, see section 61(e)(3) of Pub. L. 98-369, set out as a note under section 312 of this title.

**EFFECTIVE DATE**

Section applicable to taxable years ending after July 18, 1984, but subsec. (c) of this section effective on the day 30 days after July 18, 1984, see section 44 of Pub. L. 98-369, set out as a note under section 1271 of this title.

**PLAN AMENDMENTS NOT REQUIRED UNTIL  
JANUARY 1, 1989**

For provisions directing that if any amendments made by subtitle A or subtitle C of title XI [ §§1101-1147 and 1171-1177] or title XVIII [ §§1800-1899A] of Pub. L. 99-514 require an amendment to any plan, such plan amendment shall not be required to be made before the first plan year beginning on or after Jan. 1, 1989, see section 1140 of Pub. L. 99-514, as amended, set out as a note under section 401 of this title.

**SUBPART B—MARKET DISCOUNT ON BONDS**

Sec.	
1276.	Disposition gain representing accrued market discount treated as ordinary income.
1277.	Deferral of interest deduction allocable to accrued market discount.
1278.	Definitions and special rules.

**§ 1276. Disposition gain representing accrued market discount treated as ordinary income****(a) Ordinary income****(1) In general**

Except as otherwise provided in this section, gain on the disposition of any market discount bond shall be treated as ordinary income to the extent it does not exceed the accrued market discount on such bond. Such gain shall be recognized notwithstanding any other provision of this subtitle.

**(2) Dispositions other than sales, etc.**

For purposes of paragraph (1), a person disposing of any market discount bond in any transaction other than a sale, exchange, or involuntary conversion shall be treated as realizing an amount equal to the fair market value of the bond.

**(3) Treatment of partial principal payments****(A) In general**

Any partial principal payment on a market discount bond shall be included in gross income as ordinary income to the extent such payment does not exceed the accrued market discount on such bond.

**(B) Adjustment**

If subparagraph (A) applies to any partial principal payment on any market discount bond, for purposes of applying this section to any disposition of (or subsequent partial principal payment on) such bond, the amount of accrued market discount shall be reduced by the amount of such partial principal payment included in gross income under subparagraph (A).

**(4) Gain treated as interest for certain purposes**

Except for purposes of sections 103, 871(a), 881, 1441, 1442, and 6049 (and such other provisions as may be specified in regulations), any amount treated as ordinary income under

paragraph (1) or (3) shall be treated as interest for purposes of this title.

**(b) Accrued market discount**

For purposes of this section—

**(1) Ratable accrual**

Except as otherwise provided in this subsection or subsection (c), the accrued market discount on any bond shall be an amount which bears the same ratio to the market discount on such bond as—

(A) the number of days which the taxpayer held the bond, bears to

(B) the number of days after the date the taxpayer acquired the bond and up to (and including) the date of its maturity.

**(2) Election of accrual on basis of constant interest rate (in lieu of ratable accrual)**

**(A) In general**

At the election of the taxpayer with respect to any bond, the accrued market discount on such bond shall be the aggregate amount which would have been includible in the gross income of the taxpayer under section 1272(a) (determined without regard to paragraph (2) thereof) with respect to such bond for all periods during which the bond was held by the taxpayer if such bond had been—

(i) originally issued on the date on which such bond was acquired by the taxpayer,

(ii) for an issue price equal to the basis of the taxpayer in such bond immediately after its acquisition.

**(B) Coordination where bond has original issue discount**

In the case of any bond having original issue discount, for purposes of applying subparagraph (A)—

(i) the stated redemption price at maturity of such bond shall be treated as equal to its revised issue price, and

(ii) the determination of the portion of the original issue discount which would have been includible in the gross income of the taxpayer under section 1272(a) shall be made under regulations prescribed by the Secretary.

**(C) Election irrevocable**

An election under subparagraph (A), once made with respect to any bond, shall be irrevocable.

**(3) Special rule where partial principal payments**

In the case of a bond the principal of which may be paid in 2 or more payments, the amount of accrued market discount shall be determined under regulations prescribed by the Secretary.

**(c) Treatment of nonrecognition transactions**

Under regulations prescribed by the Secretary—

**(1) Transferred basis property**

If a market discount bond is transferred in a nonrecognition transaction and such bond is transferred basis property in the hands of the

transferee, for purposes of determining the amount of the accrued market discount with respect to the transferee—

(A) the transferee shall be treated as having acquired the bond on the date on which it was acquired by the transferor for an amount equal to the basis of the transferor, and

(B) proper adjustments shall be made for gain recognized by the transferor on such transfer (and for any original issue discount or market discount included in the gross income of the transferor).

**(2) Exchanged basis property**

If any market discount bond is disposed of by the taxpayer in a nonrecognition transaction and paragraph (1) does not apply to such transaction, any accrued market discount determined with respect to the property disposed of to the extent not theretofore treated as ordinary income under subsection (a)—

(A) shall be treated as accrued market discount with respect to the exchanged basis property received by the taxpayer in such transaction if such property is a market discount bond, and

(B) shall be treated as ordinary income on the disposition of the exchanged basis property received by the taxpayer in such exchange if such property is not a market discount bond.

**(3) Paragraph (1) to apply to certain distributions by corporations or partnerships**

For purposes of paragraph (1), if the basis of any market discount bond in the hands of a transferee is determined under section 732(a), or 732(b), such property shall be treated as transferred basis property in the hands of such transferee.

**(d) Special rules**

Under regulations prescribed by the Secretary—

(1) rules similar to the rules of subsection (b) of section 1245 shall apply for purposes of this section; except that—

(A) paragraph (1) of such subsection shall not apply,

(B) an exchange qualifying under section 354(a), 355(a), or 356(a) (determined without regard to subsection (a) of this section) shall be treated as an exchange described in paragraph (3) of such subsection, and

(C) paragraph (3) of section 1245(b) shall be applied as if it did not contain a reference to section 351, and

(2) appropriate adjustments shall be made to the basis of any property to reflect gain recognized under subsection (a).

(Added Pub. L. 98-369, div. A, title I, §41(a), July 18, 1984, 98 Stat. 543; amended Pub. L. 99-514, title VI, §631(e)(15), title XVIII, §§1803(a)(5), (13)(A), 1899A(28), Oct. 22, 1986, 100 Stat. 2275, 2793, 2796, 2960; Pub. L. 100-647, title I, §1018(u)(46), Nov. 10, 1988, 102 Stat. 3592; Pub. L. 103-66, title XIII, §13206(b)(1)(A), (2)(B)(i), Aug. 10, 1993, 107 Stat. 465; Pub. L. 115-141, div. U, title IV, §401(a)(180), Mar. 23, 2018, 132 Stat. 1193.)

## AMENDMENTS

2018—Subsec. (a)(4). Pub. L. 115-141 substituted “871(a),” for “871(a),”.

1993—Subsec. (a)(4). Pub. L. 103-66, §13206(b)(2)(B)(i), substituted “sections 103, 871(a),” for “sections 871(a)”.

Subsec. (e). Pub. L. 103-66, §13206(b)(1)(A), struck out heading and text of subsec. (e). Text read as follows: “This section shall not apply to any market discount bond issued on or before July 18, 1984.”

1988—Subsec. (b)(3). Pub. L. 100-647 designated paragraph relating to special rule where there are partial principal payments as par. (3) and inserted period at end.

1986—Subsec. (a)(3). Pub. L. 99-514, §1803(a)(13)(A)(i), added par. (3). Former par. (3) redesignated (4).

Subsec. (a)(4). Pub. L. 99-514, §1803(a)(13)(A)(i), (ii), redesignated par. (3) as (4) and substituted “under paragraph (1) or (3)” for “under paragraph (1)”.

Subsec. (b). Pub. L. 99-514, §1803(a)(13)(A)(iii), added undesignated par. at end relating to special rule where partial principal payments.

Subsec. (c)(3). Pub. L. 99-514, §631(e)(15), struck out reference to section 334(c).

Subsec. (d)(1)(C). Pub. L. 99-514, §1803(a)(5), added subpar. (C).

Subsec. (e). Pub. L. 99-514, §1899A(28), substituted “July 18, 1984” for “the date of the enactment of this section”.

## EFFECTIVE DATE OF 1993 AMENDMENT

Pub. L. 103-66, title XIII, §13206(b)(3), Aug. 10, 1993, 107 Stat. 465, provided that: “The amendments made by this section [probably should be “subsection”, which amended this section and sections 1277 and 1278 of this title] shall apply to obligations purchased (within the meaning of section 1272(d)(1) of the Internal Revenue Code of 1986) after April 30, 1993.”

## EFFECTIVE DATE OF 1988 AMENDMENT

Amendment by Pub. L. 100-647 effective, except as otherwise provided, as if included in the provision of the Tax Reform Act of 1986, Pub. L. 99-514, to which such amendment relates, see section 1019(a) of Pub. L. 100-647, set out as a note under section 1 of this title.

## EFFECTIVE DATE OF 1986 AMENDMENT

Amendment by section 631(e)(15) of Pub. L. 99-514 applicable to any distribution in complete liquidation, and any sale or exchange, made by a corporation after July 31, 1986, unless such corporation is completely liquidated before Jan. 1, 1987, any transaction described in section 338 of this title for which the acquisition date occurs after Dec. 31, 1986, and any distribution, not in complete liquidation, made after Dec. 31, 1986, with exceptions and special and transitional rules, see section 633 of Pub. L. 99-514, set out as an Effective Date note under section 336 of this title.

Amendment by section 1803(a)(5) of Pub. L. 99-514 effective, except as otherwise provided, as if included in the provisions of the Tax Reform Act of 1984, Pub. L. 98-369, div. A, to which such amendment relates, see section 1881 of Pub. L. 99-514, set out as a note under section 48 of this title.

Pub. L. 99-514, title XVIII, §1803(a)(13)(C), Oct. 22, 1986, 100 Stat. 2797, provided that: “The amendments made by this paragraph [amending this section and section 1286 of this title] shall apply to obligations acquired after the date of the enactment of this Act [Oct. 22, 1986].”

## EFFECTIVE DATE

Section applicable to taxable years ending after July 18, 1984, and applicable to obligations issued after July 18, 1984, in taxable years ending after such date, see section 44 of Pub. L. 98-369, set out as a note under section 1271 of this title.

PLAN AMENDMENTS NOT REQUIRED UNTIL  
JANUARY 1, 1989

For provisions directing that if any amendments made by subtitle A or subtitle C of title XI [§§1101-1147

and 1171-1177] or title XVIII [§§1800-1899A] of Pub. L. 99-514 require an amendment to any plan, such plan amendment shall not be required to be made before the first plan year beginning on or after Jan. 1, 1989, see section 1140 of Pub. L. 99-514, as amended, set out as a note under section 401 of this title.

**§ 1277. Deferral of interest deduction allocable to accrued market discount****(a) General rule**

Except as otherwise provided in this section, the net direct interest expense with respect to any market discount bond shall be allowed as a deduction for the taxable year only to the extent that such expense exceeds the portion of the market discount allocable to the days during the taxable year on which such bond was held by the taxpayer (as determined under the rules of section 1276(b)).

**(b) Disallowed deduction allowed for later years****(1) Election to take into account in later year where net interest income from bond****(A) In general**

If—

(i) there is net interest income for any taxable year with respect to any market discount bond, and

(ii) the taxpayer makes an election under this subparagraph with respect to such bond,

any disallowed interest expense with respect to such bond shall be treated as interest paid or accrued by the taxpayer during such taxable year to the extent such disallowed interest expense does not exceed the net interest income with respect to such bond.

**(B) Determination of disallowed interest expense**

For purposes of subparagraph (A), the amount of the disallowed interest expense—

(i) shall be determined as of the close of the preceding taxable year, and

(ii) shall not include any amount previously taken into account under subparagraph (A).

**(C) Net interest income**

For purposes of this paragraph, the term “net interest income” means the excess of the amount determined under paragraph (2) of subsection (c) over the amount determined under paragraph (1) of subsection (c).

**(2) Remainder of disallowed interest expense allowed for year of disposition****(A) In general**

Except as otherwise provided in this paragraph, the amount of the disallowed interest expense with respect to any market discount bond shall be treated as interest paid or accrued by the taxpayer in the taxable year in which such bond is disposed of.

**(B) Nonrecognition transactions**

If any market discount bond is disposed of in a nonrecognition transaction—

(i) the disallowed interest expense with respect to such bond shall be treated as interest paid or accrued in the year of dis-