

## **Rev. Proc. 92-67**

### **SECTION 1. PURPOSE**

.01 This revenue procedure provides procedures for taxpayers --

(1) Electing under section 1278(b) of the Internal Revenue Code to include market discount in income currently;

(2) Electing under the rules of section 1276(b) to use a constant interest rate to determine accrued market discount on a bond where the holder of the bond is required to determine the amount of accrued market discount at a time prior to the holder's disposition of the bond; and

(3) Requesting consent to revoke a section 1278(b) election.

.02 This revenue procedure also sets forth the circumstances under which taxpayers are treated as having made a section 1278(b) election or constant interest rate election on returns filed before September 23, 1992.

### **SEC. 2. BACKGROUND AND ANALYSIS**

#### **In General**

.01 Section 1276(a) of the Code provides that gain on the disposition of any market discount bond is treated as ordinary income to the extent of accrued market discount on the bond. Section 1276 applies to market discount bonds issued after July 18, 1984, the date of its enactment.

.02 Section 1278(a)(1) of the Code defines "market discount bond" as any bond having market discount with the exception of short-term obligations, tax-exempt obligations, United States savings bonds, and any installment obligation to which section 453B applies. The term "bond" is defined by section 1278(a)(3) as any bond, debenture, note, certificate, or other evidence of indebtedness. "Market discount" is generally defined by section 1278(a)(2) as the excess (if any) of the stated redemption price of a bond at maturity over the basis of the bond immediately after its acquisition by a taxpayer.

.03 Section 1276(a)(3) of the Code provides that any partial principal payment on a market discount bond is included in gross income as ordinary income to the extent the payment does not exceed the accrued market discount on the bond.

.04 Section 1277(a) of the Code provides that the net direct interest expense with respect to any market discount bond is allowed as a deduction for the taxable year only to the extent that the expense exceeds the portion of the market discount allocable to the days during the taxable year on which the bond was held by the taxpayer (as determined under the rules of section 1276(b)).

.05 Section 1278(b) of the Code permits a taxpayer to elect a method of accounting under which market discount is currently included in gross income for the taxable years to which the discount is attributable.

.06 Thus, for federal income tax purposes, the holder of a market discount bond must determine accrued market discount on the bond prior to the holder's disposition of the bond if--

- (1) there is a partial principal payment on the bond (see 1276(a)(3) of the Code),
- (2) there is net direct interest expense with respect to the bond (see section 1277(a) of the Code), or
- (3) a section 1278(b) election applies to the bond.

#### Election Under Section 1278(b)

.07 A section 1278(b) election applies to all market discount bonds, regardless of their issue date, that are acquired by the taxpayer on or after the first day (the "election date") of the first taxable year for which the election applies.

.08 Section 1278(b)(3) of the Code provides that a section 1278(b) election applies to the taxable year for which it is made and to all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to the revocation of the election.

.09 Sections 1276 and 1277 of the Code do not apply to bonds that are subject to a section 1278(b) election except that the rules of section 1276(b) are used to determine the amount of market discount attributable to a taxable year.

.10 Section 1278(b)(4) of the Code provides that the basis of any market discount bond to which a section 1278(b) election applies is increased by the amount included in gross income under section 1278(b)(1).

#### Election Under Section 1276(b)

.11 The rules of section 1276(b) provide for the ratable accrual of market discount or, at the election of the taxpayer, for accrual of market discount on the basis of a constant interest rate. A constant interest rate election may be made by a taxpayer on a bond-by-bond basis. For each bond with respect to which the election is made, the election is effective as of the day the bond is acquired. The election is irrevocable.

.12 A constant interest rate election must be made no later than the due date (including extensions) for the income tax return for the earliest taxable year for which the taxpayer is required to determine accrued market discount. Thus, if a section 1278(b) election applies to the discount bond, that year is the year containing the calendar day after the day on which the bond is acquired. If there is a partial principal payment on the bond, that year is no later than the year in which the first partial principal payment on the bond is required to be accounted for on a tax return of the holder. If there is net direct interest expense with respect to the bond, that year is no later than the year in which that expense would be accounted for in the absence of section 1277(a).

.13 Because the constant interest rate election is irrevocable, it remains in effect for all determinations of accrued market discount. In particular, it remains in effect without regard to whether any section 1278(b) election remains in effect, whether there are further partial principal payments on the bond, or whether there is any further net direct interest expense with respect to the bond.

.14 A constant interest rate election is a method of accounting for any bond to which it applies. Because the election is irrevocable, the Commissioner will not consent to any change of this method of accounting.

#### Revocation of a Section 1278(b) Election

.15 The revocation of a section 1278(b) election applies to all market discount bonds that are

held by the taxpayer on the first day (the "revocation date") of the first taxable year for which the revocation is effective, and to all market discount bonds that are subsequently acquired by the taxpayer.

.16 If a section 1278(b) election is revoked, then, for purposes of section 1276(a), accrued market discount with respect to any bond previously subject to the election means accrued market discount as defined in section 1276(b) less any market discount included in income while the bond was subject to the section 1278(b) election.

### Changing a Method of Accounting

.17 Section 446(e) of the Code states that, except as otherwise provided, a taxpayer must secure the consent of the Secretary before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(2)(ii)(a) of the Income Tax Regulations defines a change in method of accounting to include a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction.

.18 Because the change from including market discount in gross income upon disposition of a market discount bond to currently including market discount in gross income under section 1278(b) of the Code (or vice versa) is a change in the treatment of a material item, making or revoking a section 1278(b) election is a change in method of accounting.

.19 Section 1.446-1(e)(3)(i) of the regulations delegates to the Commissioner the Secretary's authority to consent to a change in accounting method and provides that permission to change a taxpayer's method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and the adjustments under which the change will be effected.

.20 Section 481(a) of the Code requires that those adjustments necessary to prevent amounts from being duplicated in or omitted from taxable income be taken into account when the taxpayer's taxable income for a taxable year is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year.

.21 Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting, including such procedures as may be necessary to prevent the omission or duplication of items includible in gross income or deductions. The "cut-off method" defined in section 2.05(3) of Rev. Proc. 92-20, 1992-12 I.R.B. 10, is one such procedure; when the cut-off method is used to effect a change in method of accounting, no section 481(a) adjustment is necessary or permitted (see section 2.22 below).

### No Adjustment Under Section 481

.22 When a taxpayer makes a section 1278(b) election, makes a constant interest rate election, or revokes a section 1278(b) election, no section 481(a) adjustment is necessary or permitted.

(1) A section 1278(b) election is effective only for a bond acquired on or after the election date (see section 2.07 above). A constant interest rate election, whether or not applied to a bond that is subject to a section 1278(b) election, is effective from the date the bond is acquired (see section 2.11 above). Thus, regardless of whether a bond is acquired before or after the effective date of the election, neither election can produce an omission or duplication of an item of income or deduction, because all market discount for the bond is accounted for under only one

method of accounting.

(2) Revocation of a section 1278(b) election applies not only to market discount bonds acquired by the taxpayer on and after the revocation date but also to market discount bonds held on the revocation date. The Commissioner, however, under the authority of section 446(e), will require that the change in method resulting from the revocation be implemented under a cut-off method. Under this procedure, the method change applies only to market discount accruing on or after the effective date of the revocation. Market discount accruing on a bond prior to the effective date of the revocation was currently included in income (see section 1278(b) of the Code), and market discount accruing on a bond on and after the revocation date is included in income generally upon disposition of the bond (see section 1276(a) of the Code). Because cut-off treatment is prescribed for the change in method of accounting upon revocation of a section 1278(b) election, the basis of any bond, adjusted for amounts previously included in income during the period of the election, is not affected by the revocation.

Thus, the revocation of a section 1278(b) election cannot result in an omission or duplication of an item of income or deduction, and no section 481(a) adjustment is required or permitted.

### SEC. 3. PROCEDURES FOR MAKING A SECTION 1278(b) ELECTION

.01 Scope. Section 3.02 applies to a taxpayer if--

(1) The taxpayer desires to make a section 1278(b) election for a taxable year (the election year) ending after July 18, 1984,

(2) The federal income tax return for that year is timely filed on or after September 23, 1992, and

(3) The taxpayer's most recent revocation, if any, of a prior section 1278(b) election had a revocation date (within the meaning of section 2.15 above) that was at least 5 calendar years before the election date (within the meaning of section 2.07 above).

.02 Procedure. If a taxpayer meets all of the qualifications in paragraphs (1) through (3) of section 3.01, the taxpayer makes the section 1278(b) election by attaching to the taxpayer's timely filed income tax return for the election year a statement that market discount has been included in the gross income of the taxpayer under section 1278(b) of the Code. The statement must also describe the method used by the taxpayer to determine the market discount attributable to the taxable year covered by the tax return. The election applies to all market discount bonds acquired on or after the election date (see section 1278(b) of the Code and section 2.07 above).

### SEC. 4. PROCEDURES FOR MAKING A CONSTANT INTEREST RATE ELECTION FOR A BOND

.01 Scope. Section 4.02 applies to a taxpayer that desires to make a constant interest rate election for a market discount bond acquired in a taxable year ending after July 18, 1984, and, that, on or after September 23, 1990, timely files the federal income tax return for the earliest taxable year for which the taxpayer is required to determine accrued market discount on the bond (see sections 2.06 and 2.12 above).

.02 Procedure. A taxpayer described in section 4.01 makes the constant interest rate election for the bond by attaching to that timely filed tax return a statement identifying the bond and stating

that the taxpayer is making a constant interest rate election with respect to the bond. The election is effective as of the date of the bond's acquisition and is irrevocable (see section 1276(b)(2)(C) of the Code and sections 2.11 and 2.13 above).

#### .03 Transition Rule

(1) Scope. This transition rule applies if (a) a taxpayer was required to determine accrued market discount on a bond acquired in a taxable year that ended after July 18, 1984, (b) the tax return for that year was filed before August 24, 1992, and (c) no item of income or deduction shown on the return for that year was affected by the method used by the taxpayer in computing accrued market discount on its bonds.

(2) Procedure. If a taxpayer and a bond are described in section 4.03(1), the taxpayer may make a constant interest rate election for the bond by attaching the statement described in section 4.02 to a timely filed tax return for a taxable year no later than the taxable year that includes August 24, 1992, the date this revenue procedure is published in the Internal Revenue Bulletin.

(3) Example. A taxpayer is described in section 4.03(1) if, for example, it was required to determine accrued market discount during a prior taxable year because it received a \$ 200 partial principal payment on a bond and accrued market discount would have been \$ 500 under a ratable accrual method and \$ 450 under a constant interest rate method. Thus, under either method the accrued market discount in that year exceeds the \$ 200 partial principal payment. For that reason, the taxpayer's income in that year is not affected by the method used in computing accrued market discount on its bonds.

### SEC. 5. PROCEDURES FOR MAKING A CONSTANT INTEREST RATE ELECTION FOR A CLASS OR GROUP OF BONDS

.01 Scope. This section applies to a taxpayer that desires to make a constant interest rate election for a class or group of bonds each of which could have been subject to an election by the taxpayer made under section 4 of this revenue procedure.

.02 Designation Procedure. A taxpayer described in section 5.01 may make the constant interest rate election for the class or group of bonds by attaching to a timely filed income tax return a statement describing the type or types of bonds being designated for the election. For each designated bond, the election is effective as of the date of the bond's acquisition.

.03 Example. The flexibility permitted by section 5.02 is illustrated by the following example. On March 15, 1993, T corporation files its income tax return for calendar year 1992. Attached to the timely filed return is a statement that a constant interest election is being made for the following designated obligations: (1) Five series A bonds issued by corporation M on September 15, 1989, acquired by T on July 8, 1990, and having CUSIP numbers 00000, 00001, 00002, 00003, and 00005; (2) all of the bonds issued by corporation X and acquired by T on or after June 17, 1990; (3) all of the promissory notes secured by real property acquired by T from Bank BK on June 15, 1991, except the note dated April 21, 1984, issued by C; and (4) all market discount bonds traded on the New York or American Stock Exchange that were acquired by T (or will be acquired by T) on or after January 1, 1992. (Note: Assume that T was not required to determine accrued market discount for any of these four classes of bonds for any taxable year before 1992 (see section 2.12 above).

.04 Procedures for Changing a Designation. The designation described in section 5.02 can be modified or terminated by attaching to a timely filed income tax return a statement stating that the designation is being modified or terminated and describing the bonds to which the modification or

termination applies. The modification or termination is effective for all bonds so described that are acquired on or after the first day of the taxable year for which the return is filed.

## SEC. 6. AUTOMATIC CONSENT FOR SECTION 1278(b) AND CONSTANT INTEREST RATE ELECTIONS

The consent of the Commissioner is hereby granted to a change in a taxpayer's method of accounting for market discount if (1) the change results from a section 1278(b) election or a constant interest rate election, and (2) the change is effected in accordance with this revenue procedure. (See section 7 below for procedures necessary to obtain the Commissioner's consent for revoking a section 1278(b) election.)

## SEC. 7. PROCEDURES FOR REVOKING A SECTION 1278(b) ELECTION

.01 A taxpayer must apply to the Commissioner for permission to revoke a section 1278(b) election. Except as otherwise provided in this revenue procedure, the application is subject to the procedures for a change of method of accounting, including the filing of a Form 3115 with the National Office of the Service (see Rev. Proc. 92-20).

.02 In addition to other required material, the application must include:

- (1) The reasons for revoking the election;
- (2) A description of the method by which, and the date on which, the taxpayer made the section 1278(b) election that is proposed to be revoked;
- (3) A description of the types or classes of market discount bonds that are subject to the election being revoked and that are held by the taxpayer during the proposed year of revocation;
- (4) The method under the rules of section 1276(b) of the Code that was used to determine the amount of market discount attributable to a taxable year; and
- (5) A statement that, after the revocation, the taxpayer will not make a constant interest at election for any bond that has been subject to the section 1278(b) election being revoked and for which a constant interest rate election was not effective in the year of acquisition (see section 2.13 above).

.03 A taxpayer under examination may file an application under the procedures described in section 6.02 of Rev. Proc. 92-20 (or similar procedures in any successor to that revenue procedure) even if the 90-day window referred to in that section has expired and even if, on the date of contact by the Service, the taxpayer was already under examination for another taxable year.

.04 The procedures of section 10.12 (concerning audit protection) of Rev. Proc. 92-20 (or similar procedures of any successor to that revenue procedure) are not available to taxpayers that apply under this section for permission to revoke a section 1278(b) election.

.05 The Commissioner will not ordinarily consent to the revocation of a section 1278(b) election if the requested revocation date is less than 5 calendar years after the election date.

.06 In order to assist in processing requests for a revocation of an election, reference to this revenue procedure must be made a part of the Form 3115 by typing or printing the following statement at the top of page 1 of Form 3115; FILED UNDER SECTION 7 OF REV. PROC. 92-67.

## SEC. 8. DEFINITIONS

For purposes of sections 3.01, 4.01, and 4.03 of this revenue procedure, the term "taxpayer" includes a distributor or corporation whose assets, in a transaction to which section 381(a) of the Code applies, were distributed or transferred to the taxpayer making a section 1278(b) election or a constant interest rate election.

## SEC. 9. TRANSITION PROCEDURES

### .01 Taxpayers Treated as Having Made a Section 1278(b) Election.

(1) Scope. This section applies to a taxpayer if--

(a) The taxpayer's federal income tax return for a taxable year (the "election year") ending after July 18, 1984, was or is filed before September 23, 1992, and

(b) Other than as a result of a disposition of a bond or a partial principal payment treated under section 1276(a)(3) of the Code, the gross income on that return includes the market discount attributable to that year for one or more market discount bonds that were acquired by the taxpayer during that year.

(2) Deemed Election. If a taxpayer meets all of the qualifications in subparagraphs (a) and (b) of section 9.01(1), the taxpayer is treated as having made a section 1278(b) election for the election year (and subsequent years). The election applies to all market discount bonds acquired on or after the election date (see section 1278(b) of the Code and section 2.07 above).

### .02 Taxpayers Treated as Having Made a Constant Interest Rate Election.

(1) Scope. This section applies to a taxpayer if--

(a) The taxpayer's federal income tax return for a taxable year ending after July 18, 1984, was or is filed before September 23, 1992

(b) The taxpayer held a market discount bond during that taxable year,

(c) The taxpayer was required to determine accrued market discount for purposes of the return, and

(d) One or more items of income or deduction shown on the return was affected because the taxpayer computed the accrued market discount not on a ratable basis but rather on the basis of the constant interest rate method described in section 1276(b)(2) of the Code.

If a taxpayer is described by subparagraphs (a)(c) but not subparagraph (d) of this section 9.02(1), the taxpayer may be entitled to make a constant interest rate election under section 4.03 above.

(2) Deemed Election. If, with respect to a market discount bond, a taxpayer meets all of the qualifications in subparagraphs (a) through (d) of section 9.02(1), the taxpayer is treated as having made a constant interest rate election for that bond. The election for that bond is irrevocable (see section 1276(b)(2)(C) of the Code and sections 2.11 and 2.13 above).

### .03 Elections Inconsistent with These Transition Procedures.

(1) Scope. This section applies if, prior to September 23, 1992 and based upon a reasonable interpretation of the Code, a taxpayer attempted to make a section 1278(b) election or a constant interest rate election in a manner inconsistent with this revenue procedure. Depending on the nature of the taxpayer's request, the taxpayer should seek appropriate relief by either requesting a change in method of accounting or requesting a ruling. For appropriate procedures, see sections 9.03(2) and 9.03(3).

(2) Application for Change in Method of Accounting.

A taxpayer described in section 9.03(1) that desires to change its method of accounting must file an application with the Commissioner in accordance with the procedures of Rev. Proc. 92-20 (or its successor) to either conform its method with the elections and methods permitted under this revenue procedure or revoke its non-conforming section 1278(b) election. In addition to any other required information, the taxpayer must describe the interpretation of the Code upon which it relied in making the inconsistent election and must briefly describe why the interpretation is reasonable. In order to assist in processing requests under this section, reference to this revenue procedure must be made a part of the Form 3115 by typing or printing the following statement at the top of page 1 of Form 3115: FILED UNDER SECTION 9.03(2) OF REV. PROC. 92-67.

(3) Letter Ruling. For issues not involving a change in method of accounting, a taxpayer described in section 9.03(1) may request a ruling under Rev. Proc. 92-1, 1992-1 I.R.B. 7 (or its successor).

## SEC. 10. INQUIRIES

Inquiries about this revenue procedure should be addressed to the Internal Revenue Service, Assistant Chief Counsel (Financial Institutions and Products), Attn: CC:FI&P:2, 1111 Constitution Avenue N.W., Washington D.C. 20224.

## SEC. 11. EFFECT ON OTHER DOCUMENTS

Rev. Rul. 73-60, 1973-1 C.B. 332, provides that current accrual of market discount is a method of accounting. Thus, a change to or from that method requires the consent of the Commissioner. Rev. Rul. 73-60 is modified to the extent that it suggests that taxpayers should obtain that consent in a manner different from that described in this revenue procedure.