

## Internal Revenue Service

## Department of the Treasury

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Date:

September 28, 2001

### **LEGEND:**

Applicant =

Parent =

Corporation A =

Corporation B =

Date 1 =

Date 2 =

This letter responds to a ruling request submitted on behalf of Applicant on Date 1 with respect to the proper treatment of amortizable bond premium following a reorganization to which §§ 368, 361 and 381 of the Internal Revenue Code apply.<sup>1</sup>

### **FACTS**

Applicant is a subsidiary corporation that joins in the filing of consolidated federal income tax returns with Parent. Applicant acquires debt instruments at a premium and has amortizable bond premium within the meaning of § 171(b) on debt instruments ("premium bonds") that are described in § 171(d).

The following representations have been made by Applicant and Parent (together, the "Taxpayer"). As of Date 2, all of Applicant's premium bonds were taxable bonds within the meaning of § 171(a)(1). All of Applicant's premium bonds were originally issued after September 27, 1987. Further, all of Applicant's premium bonds were mortgage-backed securities ("MBS"), including regular interests in real estate mortgage investment conduits ("REMIC regular interests") and collateralized mortgage obligations ("CMOs"). None of Applicant's premium bonds were mortgage pass-thru certificates of the kind described in Rev. Rul. 84-10, 1984-1 C.B. 156.

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<sup>1</sup> Based on the represented date of transfer, the request was timely filed within the meaning of § 1.381(c)(4)-1(d)(2) of the Income Tax Regulations.

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On Date 2, Parent acquired Corporation A by means of a merger that qualifies as a reorganization to which §§ 368, 361 and 381 apply. In connection with this acquisition, Corporation B (a subsidiary of Corporation A) was merged with and into Applicant in a transaction that also qualifies as a reorganization to which §§ 368, 361 and 381 apply. The date of transfer with respect to this transaction was Date 2. Taxpayer further represents that Applicant is the acquiring corporation with respect to the assets transferred by Corporation B on Date 2.

Prior to Date 2, Applicant and Corporation B had each made an election to amortize bond premium under former § 1.171-3. Pursuant to its election, Applicant amortized bond premium using a straight-line method. Pursuant to its election, Corporation B (which, as of Date 2, also held only taxable premium bonds of the kind held by Applicant) used a different method from that used by Applicant to account for its amortizable bond premium.<sup>2</sup> As of Date 2, Applicant's premium bond holdings exceeded those of Corporation B.

#### APPLICABLE LAW

If a transfer is in connection with a reorganization described in § 368(a)(1)(A), a corporation that acquires the assets of another corporation in a transfer to which § 361 applies is required to succeed to and take into account, as of the close of the day of that transfer, the items described in § 381(c) of the transferor corporation. See § 381(a)(2); §§ 1.381(a)-1(a) and 1.381(a)-1(b)(1)(ii).

Under § 1.381(a)-1(b)(2), the acquiring corporation is that corporation which ultimately acquires the assets transferred by the transferor corporation in a transaction to which § 381(a)(2) applies.

Under § 1.381(b)-1(b)(1), the date of transfer is defined as that day on which are transferred all those properties of the transferor corporation which are to be transferred pursuant to the reorganization.

Pursuant to § 381(c)(4), the acquiring corporation is required to use the method of accounting used by the transferor corporation on the date of transfer unless different methods were used by the transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation must use the method or combination of methods of accounting adopted pursuant to regulations prescribed by the Secretary. See § 1.381(c)(4)-1(a)(1)(i).

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<sup>2</sup> It is assumed, in the absence of any information to the contrary, that prior to Date 2 neither Applicant nor Corporation B were required by closing agreement to use their respective methods of accounting for amortizing bond premium.

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Section 1.381(c)(4)-1(b) provides special conditions for the continuation of methods of accounting following a § 381(a) transaction. However, where only a single method of accounting may be used by a taxpayer for a particular item regardless of the number of separate and distinct trades or businesses operated by that taxpayer, the acquiring corporation shall adopt the principal method of accounting under § 1.381(c)(4)-1(c)(2)(iv) unless the method of accounting must be determined in accordance with § 1.381(c)(4)-1(d).

Pursuant to § 1.381(c)(4)-1(c)(1), the acquiring corporation is required to use the principal method of accounting (as determined under § 1.381(c)(4)-1(c)(2)) provided that it clearly reflects the income of the acquiring corporation and its use is not inconsistent with the provisions of any applicable closing agreement. Pursuant to § 1.381(c)(4)-1(d)(1)(i), if the principal method of accounting does not clearly reflect income and, consequently can not be used by the acquiring corporation, the Commissioner shall determine the appropriate method of accounting to be used.

Under § 1.381(c)(4)-1(a)(2), the term "method of accounting" has the same meaning as that provided under § 446 and the regulations thereunder. The amount of any adjustments necessary to reflect a required change in method of accounting under these provisions, the manner in which such adjustments are to be taken into account, and the tax attributable thereto, shall be determined and computed under § 481 and the regulations thereunder, subject to the rules provided in §§ 1.381(c)(4)-1(c) and (d). See § 1.381(c)(4)-1(a)(1)(ii).

Special methods of accounting for particular items of income and expense are provided in the Code. See § 1.446-1(c)(1)(iii). Section 171 provides special rules with respect to amortizable bond premium that must be used by a taxpayer to account for amortizable bond premium.

Pursuant to § 1.381(c)(4)-1(c)(2)(iv), if a single method of accounting must be used by a taxpayer with respect to a particular item, the principal method of accounting for such item shall be determined by comparing the aggregate amount of the item and related accounts for the parties to the § 381(a) transaction. The method of accounting of the party having the greatest aggregate amount of such item and related accounts shall be the principal method of accounting for that item.

No method of accounting is acceptable unless, however, in the opinion of the Commissioner, that method clearly reflects income. See § 1.446-1(c)(1)(ii)(C).

For purposes of § 171, a bond means any bond, debenture, note or certificate or other evidence of indebtedness, but does not include any such obligation which (to the holder) constitutes stock in trade, or would otherwise be included in inventory if on hand at the close of the taxable year, or is held primarily for sale to customers in the ordinary course of business. See § 171(d).

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The amount of amortizable bond premium for a taxable year is determined in accordance with § 171(b) and, pursuant to § 171(e), is generally treated as an offset to interest payments. In general, under § 171(b)(3), bond premium is amortized based on the bond's yield to maturity, which is determined by using the taxpayer's basis in the obligation upon acquisition and compounding at the close of each accrual period. In the case of bonds described in § 1272(a)(6)(C), rules similar to those in § 1272(a)(6) should be used to amortize any bond premium on these bonds. See H.R. Conf. Rep. No. 841, 99<sup>th</sup> Cong., 2d Sess., pt. II, at 842 (1986), 1986-3 C.B. Vol. 4 at 842. However, as explained in footnote 5 of this letter, for purposes of applying the rules in § 1272(a)(6) to amortize bond premium on these bonds, a prepayment assumption of zero should be used.

Regulations have been issued under § 171. See §§ 1.171-1 through 1.171-5. However, these regulations do not apply to certain bonds, including regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments (or pools of debt instruments) with payments subject to acceleration as described in § 1272(a)(6)(C). See § 1.171-1(b)(2)(i).

#### ANALYSIS AND CONCLUSION

Prior to Date 2, both Applicant and Corporation B had elections in place under which they each amortized bond premium on premium bonds. As represented by Taxpayer, the merger of Corporation B with and into Applicant was accomplished in a transaction that qualifies as a reorganization to which §§ 368, 361 and 381(a) apply. Consequently, the rules with respect to the carryover of the parties' respective methods of accounting for amortizable bond premium are governed by § 381(c)(4) and the regulations thereunder.

Amortizable bond premium is an item that must be accounted for by a holder using a single method of accounting. Thus, following the acquisition of Corporation B by merger into Applicant, amortizable bond premium on all premium bonds held by Applicant after Date 2 must be accounted for using a single method of accounting.

Under § 1.381(c)(4)-1(c)(2)(iv), Applicant's straight-line method would otherwise be the principal method of accounting with respect to this item. Section 171, however, requires the use of a constant yield method. A method of accounting with respect to amortizable bond premium on such bonds that does not satisfy the statutory requirements of §§ 171(b) and (e) will not clearly reflect income.<sup>3</sup>

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<sup>3</sup> Regulations have been promulgated under § 171 that provide for a constant yield method of accounting for amortizable bond premium. As so promulgated, §§ 1.171-1 through 1.171-5 do not apply to certain bonds, including regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments (or pools of debt instruments) with payments subject to acceleration as described in

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Because the Applicant's straight-line method does not satisfy the statutory requirements of §§ 171(b) and (e), it does not clearly reflect income as required by § 446. Consequently, Applicant may not continue to use the straight-line method with respect to amortizing bond premium. See § 1.381(c)(4)-1(c)(1). Instead the Commissioner is required to determine the appropriate method of accounting for amortizable bond premium to be used by Applicant following Date 2. See § 1.381(c)(4) -1(d)(1)(i).

Pursuant to the exercise of the Commissioner's authority in § 1.381(c)(4) -1(d)(1)(i), Applicant is required to change its method of accounting for amortizable bond premium to the Proposed Method as described in this letter. Under the Proposed Method, Applicant will:

- (a) Amortize bond premium on a premium bond using a constant yield method in accordance with § 171.
- (b) Make the determinations required under §§ 171(b)(1) and (b)(2) in accordance with the bond's yield to maturity as prescribed by § 171(b)(3).
- (c) Recover amortizable bond premium by way of offset against qualified stated interest payments from the bond in accordance with § 171(e).
- (d) Under § 171(b)(3), use the following formula for calculating amortizable bond premium on its premium bonds:

$$\text{Premium for period } (n) = \text{AAP } (n) - P (n) - \text{AAP } (n+1)$$

In this formula, AAP  $(n)$  refers to the adjusted acquisition price of the bond at the beginning of accrual period  $(n)$  and P  $(n)$  refers to the amount of payments (other than payments of qualified stated interest) made during accrual period  $(n)$  on the bond. AAP  $(n)$  equals the present value of all remaining payments to be made on the bond.<sup>4</sup> This present value is determined by using the bond's yield to the holder, calculated as of the date the holder acquires the premium bond. In determining the expected remaining payments and the yield of a premium bond, assume no

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§ 1272(a)(6)(C). See § 1.171-1(b)(2)(i). Applicant's premium bonds are described in § 1.171-1(b)(2)(i). Therefore, §§ 1.171-1 through 1.171-5 do not apply directly to Applicant's premium bonds.

<sup>4</sup> AAP  $(n)$  for the first accrual period is generally the holder's purchase price.

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prepayments on the bond (in effect, the prepayment assumption will be zero for purposes of amortizing the bond premium).<sup>5</sup>

(e) Account for the corresponding reduction in the basis of a premium bond in accordance with § 1016(a)(5).

Applicant is required to take into account any increase or decrease in tax resulting from the change in method authorized in this letter for both itself and Corporation B as required by § 1.381(c)(4)-1(d)(1)(iii). The adjustments necessary to reflect such change (and the resulting increase or decrease in tax) shall be determined and computed in the same manner as if, on Date 2, both Applicant and Corporation B had initiated a change in method of accounting. Id.

Accordingly, we conclude that Applicant must recompute the amount of the tax adjustment required to be taken into account under the rules required by § 1.381(c)(4)-1(d)(1)(iii) (after giving effect to the method authorized in this letter for amortizing bond premium), and that such adjustment is required to be taken into account in full, in accordance therewith, in the year of transfer.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations or any other guidance, to the extent the guidance is inconsistent with any conclusion in the letter ruling. See section 12.04 of Rev. Proc. 2001-1, 2001-1 I.R.B. 1, 46. However, when the criteria in section 12.05 of Rev. Proc. 2001-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the authorized representative.

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<sup>5</sup> A bond that is prepayable is a bond subject to a call and, therefore, subject to the rules in § 171(b) for callable bonds. For example, bond premium on a callable bond is determined and amortized by reference to an earlier call date only if the use of the call date (rather than the bond's stated maturity date) would result in a slower recovery of premium. See § 171(b)(1)(B)(ii). Generally, in the case of mortgage backed securities (such as the premium bonds at issue here) the use of a prepayment assumption other than zero to compute accruals of bond premium would be inconsistent with the statutory rules in § 171(b) for callable bonds.

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A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely yours,  
WILLIAM E. COPPERSMITH  
Chief, Branch 2  
Office of Associate Chief Counsel  
(Financial Institutions & Products)