and losses on securities that are debt instruments. In general, immediately before a debt instrument is marked to market, Code provisions related to calculating interest must be applied, and basis must be correspondingly adjusted. The mark-to-market computations do not affect either the amount treated as interest earned from a debt instrument or the taxable years in which that interest is taken into account.

For example, immediately before a debt instrument is marked to market, accruals of unpaid qualified stated interest (QSI) must be taken into account, and basis must be correspondingly increased. This is true regardless of the taxpayer's regular method of accounting. Marking a debt instrument to market under section 475(a) precludes the deferral that a cashbasis taxpayer might have experienced in the absence of the statutory provision, and the current accrual under the proposed regulations is needed in order to preserve the interest character of the QSI.

For debt instruments acquired with original issue discount or market discount, the proposed regulations require that, immediately before the mark-to-market gain or loss is computed under section 475(a), any OID or market discount accrued through the date of computation must be taken into account, and basis must be correspondingly increased. The amount of discount attributable to a particular period of time is computed under sections 1272 through 1275 (in the case of OID) and sections 1276 through 1278 (in the case of market discount). Thus, for example, the computation of OID attributable to a particular period takes into account any reduction for acquisition premium under section 1272(a)(7).

As indicated in the preceding paragraph, the proposed regulations provide that, in the case of a market discount bond to which section 475(a) applies, the holder must take market discount into account as it accrues, regardless of whether the holder elected under section 1278(b) to do so for all of its bonds. This rule is necessary to prevent market discount from producing gain on the mark instead of interest income. This provision, however, does not impose a section 1278(b) election on the taxpayer, because it does not apply to bonds that are not marked to market under section 475.

For taxable debt instruments acquired with amortizable bond premium, the proposed regulations provide that, if a dealer has made an election to amortize premium under section 171, any

amortization for the taxable year (or for the portion of the taxable year during which the instrument is held by the dealer) must be taken into account (and basis must be appropriately reduced) before the mark-to-market gain or loss is computed under section 475. Because section 171 applies only to instruments not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, this proposed regulatory provision is applicable only to premium instruments described in section 475(b)(1) for which the taxpayer has not made the identification described in section 475(b)(2).

In the case of tax-exempt bonds, the proposed regulations require basis to be reduced as required by section 1016(a)(5) or (6) before mark-to-market

gain or loss is computed.

If a dealer acquires a bond with premium and a section 171 election first applies to the bond in a taxable year after the year of acquisition, the proposed regulations require the dealer to amortize premium based on the original basis, without regard to any mark-to-market adjustments that may have been taken into account before the section 171 election became effective, but with regard to the adjustments required under section 171(b)(1). Thus, for example, if a dealer acquires in year 1 an instrument that is subject to section 475(a) and that has \$10 of amortizable premium and if the dealer makes an election to amortize premium that is first effective in year 4 (when unamortized premium attributable to years 1 through 3 is \$4), the dealer takes into account the appropriate portion of the remaining \$6 of amortizable bond premium (as required under section 171(b)(3)) each taxable year before computing the mark-to-market adjustment on the instrument. Any mark-to-market basis adjustments in taxable years 1 through 3 are ignored in determining the amount of amortizable bond premium to which the election applies.

Under section 475(a)(2), a dealer in securities recognizes mark-to-market gain or loss on a security, other than inventory, as if the security were sold on the last business day of the taxable year. Although there may be circumstances under which marking a security to market produces results similar to the actual sale of the security, the statutory reference to the deemed sale prescribes the amount of gain or loss to be taken into account and does not trigger all of the consequences of a sale and reacquisition under the Code. For example, when a dealer in securities marks a bond (or other security) to market and takes recognized gain or loss

into account, the dealer has not actually sold and reacquired the bond. Thus, under the proposed regulations, marking a debt instrument does not create, increase, or reduce market discount, acquisition premium, or bond premium.

The proposed regulations also contain a special rule to provide the proper character for mark-to-market gains or losses on a market discount instrument that was originally identified as held for investment by the dealer. This rule is necessary to ensure that all market discount is ultimately characterized as interest income and not as gain from the sale of a security.

## Worthless Debts

The proposed regulations provide rules for marking a partially or wholly worthless debt to market. These rules coordinate the mark-to-market rules with the bad debt rules under the Code. The amount of gain or loss recognized under section 475(a)(2) when a debt instrument is marked to market generally is the difference between the adjusted basis and the fair market value of the debt. Under the proposed regulations, if a debt becomes partially or wholly worthless during a taxable year, the amount of any gain or loss required to be taken into account under section 475(a) is determined using a basis that reflects the worthlessness. The basis of the mark-to-market debt is treated as having been reduced by the amount of any book or regulatory charge-off (including the establishment of a specific allowance for a loan loss) for which a deduction could have been taken, without regard to whether any portion of the charge-off is, in fact, deducted or charged to a tax reserve for bad debts. The difference between this adjusted basis and the fair market value of the debt is the amount of gain or loss to be taken into account under section 475(a)(2). Thus, if the debt is wholly worthless, its basis would be reduced to zero and no gain or loss would be taken into account under section 475(a)(2).

This proposed treatment preserves the longstanding distinctions between losses due to the worthlessness of debts and other losses on debt instruments held by a taxpayer. See § 1.166–1(a), which requires bad debts to be taken into account either as a specific deduction in respect of debts or as a deduction for a reasonable addition to a reserve for bad debts. See also §§ 1.585-3 and 1.593-7(c), which require a reserve-method taxpayer to charge bad debts to the reserve for bad debts. In addition, computing the mark-to-market adjustment as if the debt's basis had been adjusted to reflect worthlessness