- (e) Recognition of market discount that accrued before section 475(a) applies to a market discount bond—(1) General rule. In the case of a debt instrument that is acquired with market discount, that is not subject to an election under section 1278(b), and that first becomes subject to section 475(a) in the taxpayer's hands on a date after its acquisition, this paragraph (e) governs the recognition of market discount that is attributable (as determined under section 1276(b)) to any period before section 475(a) applies to the debt instrument. To the extent that the market discount described in the preceding sentence is greater than the excess, if any, of the fair market value of the debt instrument at the time it became subject to section 475(a) over its adjusted basis at that time, section 1276(a)(1) applies to any gain recognized under section 475(a). To the extent of any remaining market discount that had accrued before section 475(a) became applicable, section 1276(a) applies no later than it would have applied if section 475(a) did not apply to the bond. For example, section 1276(a) applies to the previously accrued market discount as partial principal payments are made. Except as provided in the preceding sentences, gain recognized under section 475(a) is not recharacterized as interest by section 1276(a).
- (2) *Examples.* The rules of paragraphs (d) and (e) of this section are illustrated by the following examples:

## Example 1.

- (i) Facts. Bond X was issued on January 1, 1996, for \$1,000. Bond X matures on December 31, 2005, provides for a principal payment of \$1,000 on the maturity date, and provides for interest payments at a rate of 8%, compounded annually, on December 31 of each year. D is a dealer in securities within the meaning of section 475(c)(1). On January 1, 1997, *D* purchased bond *X* for \$955. *D* had not elected under section 1278(b) to include market discount in gross income currently. Under section 475(b), section 475(a) did not apply to bond X until January 1, 1999, at which time bond X had a fair market value of \$961. On December 31, 1999, bond X had a fair market value of \$980.
- (ii) *Holdings*. In the absence of an election under section 1276(b)(2), market discount on bond *X* accrues under section 1276(b)(1) at the rate of \$5 per year. On January 1, 1999, when bond *X* became subject to section 475(a), \$10 of market discount had accrued, but the excess of the bond's fair market value on January 1, 1999, over its adjusted basis on that date (the built-in gain) was only \$6 (\$961—\$955). During 1999, *D* is required to include as interest income the \$5 of market discount that accrues during that year, and *D* increases by that amount its basis in the bond and the amount to be used in computing mark-to-market gain or loss. On December 31,

1999, B must mark bond X to market and recognize a gain of \$14 (\$980—[\$961 + \$5]). Under section 1276(a)(1) and (4) and paragraph (e)(1) of this section, \$4 of that \$14 gain is treated as interest income. The \$4 is the amount by which the market discount of \$10 that had accrued on January 1, 1999, exceeded the \$6 built-in gain on that date.

Example 2.

- (i) *Facts*. The facts are the same as in *Example 1*, except that, in addition, *D* sells bond *X* for its fair market value of \$1,000 on June 30, 2000.
- (ii) Holdings. Immediately before the sale, D is required to include as interest income the \$2.50 of market discount that accrued during the portion of the year through June 30, and D increases by that amount its basis in the bond and the amount to be used in computing mark-to-market gain or loss. Also, under § 1.475(a)-2, immediately before the sale, D recognizes \$17.50 of mark-to-market gain (the increase in value since the preceding mark to market, less the basis increase of \$2.50 from the market discount accrual. See § 1.475(a)-2). On the sale, D also recognizes the \$6 of built-in gain, all of which is recharacterized as ordinary interest income under section 1276(a)(4).

Example 3.

(i) Facts. The facts are the same as in Example 1, except that, during 2001, the issuer of bond *X* made a partial principal

payment in the amount of \$20.

- (ii) *Holdings*. Under paragraph (e)(1) of this section and section 1276(a)(4), \$6 of the partial principal payment is included in *D*'s 2001 income as interest income. The \$6 is the portion of the \$10 of market discount that had accrued at the time bond *X* became subject to section 475(a) and that had not previously caused gain or a partial principal payment to be treated as interest income.
- (f) Worthless debts—(1) Computation of mark-to-market gain or loss. This paragraph (f) applies to any dealer that, under section 475(a)(2), marks to market either a debt that was charged off during the year because it became partially worthless or a debt that became wholly worthless during the taxable year (without regard to whether the debt was charged off). Any gain or loss attributable to marking a debt to market is determined by deeming the debt's adjusted basis to be the debt's adjusted basis under § 1.1011–1, less the amount charged off during the taxable year or during any prior taxable year, to the extent that amount has not previously reduced tax basis. A debt that becomes wholly worthless is deemed to have an adjusted basis of zero. The deemed adjusted basis, however, is used solely for this paragraph (f). Thus, any portion of a loss attributable to a bad debt continues to be accounted for under the bad debt provisions of the Code, and the basis of the debt continues to be adjusted as otherwise required under the Code.
- (2) Treatment of mark-to-market gain or loss. To the extent that a debt has

- been previously charged off, mark-tomarket gain is treated as a recovery. Thus, for example, a dealer using the section 585 reserve method of accounting for bad debts must credit to the reserve any portion of mark-tomarket gain that is treated as a recovery of a bad debt previously charged to the reserve account, and the dealer must include any excess in gross income as required by § 1.585–3(a). Similarly, if a dealer is a large bank that changed to the specific charge-off method of accounting for bad debts using the elective cut-off procedures described in § 1.585–7, the dealer must charge to the reserve for pre-disqualification loans all losses recognized as a result of marking to market a debt that is a predisqualification loan within the meaning of § 1.585-7(b)(2). Marking a pre-disqualification loan to market, however, is not a disposition of that loan under § 1.585-7(d).
- (g) Additional rules applicable to reserve-method taxpayers. If a dealer accounts for bad debts using the reserve method of accounting under section 585 or 593, the following additional rules apply in computing a reasonable addition to a reserve—
- (1) To determine the amount of total loans outstanding, the outstanding balance on a debt that is marked to market is increased or decreased by the amount of any mark-to-market gain or loss recognized, except that the outstanding balance of the debt may never exceed the actual balance currently due; and
- (2) If the reasonable addition to the reserve is computed based on a percentage of taxable income, any gain or loss attributable to marking a debt to market must be taken into account in computing taxable income.
- (h) *Example*. This example illustrates paragraphs (f) and (g) of this section.

Example.

- (i) *B*, a calendar year taxpayer, is a dealer that marks some of its debts to market under section 475(a)(2). Additionally, *B* is a bank that accounts for bad debts using the section 585 reserve method of accounting. *B* has not made an election to use the conformity method of accounting described in § 1.166–2(d)(3).
- (ii) On December 31, 1995, B has total loans outstanding of \$1,000,000 and a bad debt reserve balance of \$1000. Among the loans that B marks to market is loan X. On January 1, 1995, loan X had a book and tax basis of \$100. During the taxable year, loan taxable became partially worthless, and B charged off the loan by \$5. Thus, loan X had a book basis of \$95 and a tax basis of \$100. The fair market value of loan X was \$94 on December 31, 1995.
- (iii) B computes the amount of gain or loss to be taken into account under section