

that the annuity contract is a contract to which section 72 applies and was issued in a transaction where there is no consideration other than cash or another qualifying annuity contract, pursuant to the exercise of an election under an insurance contract by a beneficiary thereof on the death of the insured party, or in a transaction involving a qualified pension or employee benefit plan. The examples are as follows:

Example 1. Company X is an insurance company that is organized, licensed and doing business in Country Y. Company X does not have a U.S. trade or business and is not, under section 842, subject to U.S. income tax under subchapter L with respect to income earned on annuity contracts. A, a U.S. taxpayer, purchases an annuity contract from Company X in Country Y. The annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 2. The facts are the same as in Example 1, except that Company X has a U.S. trade or business. A purchased the annuity from Company X's U.S. trade or business. Under section 842(a), Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Under these facts, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 3. The facts are the same as in Example 2, except that there is a tax treaty between Country Y and the United States. Company X is a resident of Country Y for purposes of the U.S.-Country Y tax treaty. Company X's activities in the U.S. do not constitute a permanent establishment under the U.S.-Country Y tax treaty. Because Company X does not have a U.S. permanent establishment, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 4. The facts are the same as in Example 1, except that Company X is a foreign insurance corporation controlled by a U.S. shareholder. Company X does not make an election 1 under section 953(d) to be treated as a domestic corporation. The controlling U.S. shareholder is required under sections 953 and 954 to include income earned on the annuity contract in its taxable income under subpart F. However, Company X is not subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is not excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

Example 5. The facts are the same as in Example 4, except that Company X properly

elects under section 953(d) to be treated as a domestic corporation. By reason of its election, Company X is subject to tax under subchapter L with respect to income earned on the annuity contract. Thus, the annuity contract is excepted from the definition of a debt instrument by section 1275(a)(1)(B)(ii).

(3) *Effective date.* This paragraph (k) is applicable for interest accruals on or after June 6, 2002. This paragraph (k) does not apply to an annuity contract that was purchased before January 12, 2001. For purposes of this paragraph (k), if any additional investment in a contract purchased before January 12, 2001, is made on or after January 12, 2001, and the additional investment is not required to be made under a binding written contractual obligation that was entered into before that date, then the additional investment is treated as the purchase of a contract after January 12, 2001.

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§ 1.1275-2 Special rules relating to debt instruments.

(a) *Payment ordering rule—(1) In general.* Except as provided in paragraph (a)(2) of this section, each payment under a debt instrument is treated first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Thus, no portion of any payment is treated as prepaid interest.

(2) *Exceptions.* The rule in paragraph (a)(1) of this section does not apply to—

(i) A payment of qualified stated interest;

(ii) A payment of points deductible under section 461(g)(2), in the case of the issuer;

(iii) A pro rata prepayment described in paragraph (f)(2) of this section; or

(iv) A payment of additional interest or a similar charge provided with respect to amounts that are not paid when due.

(b) *Debt instruments distributed by corporations with respect to stock—(1) Treatment of distribution.* For purposes of determining the issue price of a debt instrument distributed by a corporation

with respect to its stock, the instrument is treated as issued by the corporation for property. See section 1275(a)(4). Thus, under section 1273(b)(3), the issue price of a distributed debt instrument that is traded on an established market is its fair market value. The issue price of a distributed debt instrument that is not traded on an established market is determined under section 1274 or section 1273(b)(4).

(2) *Issue date.* The issue date of a debt instrument distributed by a corporation with respect to its stock is the date of the distribution.

(c) *Aggregation of debt instruments*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, debt instruments issued in connection with the same transaction or related transactions (determined based on all the facts and circumstances) are treated as a single debt instrument for purposes of sections 1271 through 1275 and the regulations thereunder. This rule ordinarily applies only to debt instruments of a single issuer that are issued to a single holder. The Commissioner may, however, aggregate debt instruments that are issued by more than one issuer or that are issued to more than one holder if the debt instruments are issued in an arrangement that is designed to avoid the aggregation rule (e.g., debt instruments issued by or to related parties or debt instruments originally issued to different holders with the understanding that the debt instruments will be transferred to a single holder).

(2) *Exception if separate issue price established.* Paragraph (c)(1) of this section does not apply to a debt instrument if—

(i) The debt instrument is part of an issue a substantial portion of which is traded on an established market within the meaning of § 1.1273-2(f); or

(ii) The debt instrument is part of an issue a substantial portion of which is issued for money (or for property traded on an established market within the meaning of § 1.1273-2(f)) to parties who are not related to the issuer or holder and who do not purchase other debt instruments of the same issuer in connection with the same transaction or related transactions.

(3) *Special rule for debt instruments that provide for the issuance of additional debt instruments.* If, under the terms of a debt instrument (the original debt instrument), the holder may receive one or more additional debt instruments of the issuer, the additional debt instrument or instruments are aggregated with the original debt instrument. Thus, the payments made pursuant to an additional debt instrument are treated as made on the original debt instrument, and the distribution by the issuer of the additional debt instrument is not considered to be a payment made on the original debt instrument. This paragraph (c)(3) applies regardless of whether the right to receive an additional debt instrument is fixed as of the issue date or is contingent upon subsequent events. See § 1.1272-1(c) for the treatment of certain rights to issue additional debt instruments in lieu of cash payments.

(4) *Examples.* The following examples illustrate the rules set forth in paragraphs (c)(1) and (c)(2) of this section.

Example 1. Exception for debt instruments issued separately to other purchasers. On January 1, 1995, Corporation M issues two series of bonds, Series A and Series B. The two series are sold for cash and have different terms. Although some holders purchase bonds from both series, a substantial portion of the bonds is issued to different holders. H purchases bonds from both series. Under the exception in paragraph (c)(2)(ii) of this section, the Series A and Series B bonds purchased by H are not aggregated.

Example 2. Tiered REMICs. Z forms a dual tier real estate mortgage investment conduit (REMIC). In the dual tier structure, Z forms REMIC A to acquire a pool of real estate mortgages and to issue a residual interest and several classes of regular interests. Contemporaneously, Z forms REMIC B to acquire as qualified mortgages all of the regular interests in REMIC A. REMIC B issues several classes of regular interests and a residual interest, and Z sells all of those interests to unrelated parties in a public offering. Under the general rule set out in paragraph (c)(1) of this section, all of the regular interests issued by REMIC A and held by REMIC B are treated as a single debt instrument for purposes of sections 1271 through 1275.

(d) *Special rules for Treasury securities*—(1) *Issue price and issue date.* The issue price of an issue of Treasury securities is the average price of the securities sold. The issue date of an issue of

Treasury securities is the first settlement date on which a substantial amount of the securities in the issue is sold. For an issue of Treasury securities sold from November 1, 1998, to March 13, 2001, the issue price of the issue is the price of the securities sold at auction.

(2) *Reopenings of Treasury securities—*

(i) *Treatment of additional Treasury securities.* Notwithstanding § 1.1275-1(f), additional Treasury securities issued in a qualified reopening are part of the same issue as the original Treasury securities. As a result, the additional Treasury securities have the same issue price, issue date, and (with respect to holders) the same adjusted issue price as the original Treasury securities. This paragraph (d)(2) applies to qualified reopenings that occur on or after March 25, 1992.

(ii) *Definitions—(A) Additional Treasury securities.* Additional Treasury securities are Treasury securities with terms that are in all respects identical to the terms of the original Treasury securities.

(B) *Original Treasury securities.* Original Treasury securities are securities comprising any issue of outstanding Treasury securities.

(C) *Qualified reopening—reopenings on or after March 13, 2001.* For a reopening of Treasury securities that occurs on or after March 13, 2001, a qualified reopening is a reopening that occurs not more than one year after the original Treasury securities were first issued to the public or, under paragraph (k)(3)(iii) of this section, a reopening in which the additional Treasury securities are issued with no more than a de minimis amount of OID. For a reopening of Treasury securities that occurs on or after September 13, 2012, a qualified reopening also is a reopening of Treasury securities that is described in paragraph (k)(3)(v) of this section.

(D) *Qualified reopening—reopenings before March 13, 2001.* For a reopening of Treasury securities that occurs before March 13, 2001, a qualified reopening is a reopening that occurs not more than one year after the original Treasury securities were first issued to the public. However, for a reopening of Treasury securities (other than Treasury Inflation-Indexed Securities) that occurred

prior to November 5, 1999, a qualified reopening is a reopening of Treasury securities that satisfied the preceding sentence and that was intended to alleviate an acute, protracted shortage of the original Treasury securities.

(e) *Disclosure of certain information to holders.* Certain provisions of the regulations under section 163(e) and sections 1271 through 1275 provide that the issuer's determination of an item controls the holder's treatment of the item. In such a case, the issuer must provide the relevant information to the holder in a reasonable manner. For example, the issuer may provide the name or title and either the address or telephone number of a representative of the issuer who will make available to holders upon request the information required for holders to comply with these provisions of the regulations.

(f) *Treatment of pro rata prepayments—*

(1) *Treatment as retirement of separate debt instrument.* A pro rata prepayment is treated as a payment in retirement of a portion of a debt instrument, which may result in a gain or loss to the holder. Generally, the gain or loss is calculated by assuming that the original debt instrument consists of two instruments, one that is retired and one that remains outstanding. The adjusted issue price, holder's adjusted basis, and accrued but unpaid OID of the original debt instrument, determined immediately before the pro rata prepayment, are allocated between these two instruments based on the portion of the instrument that is treated as retired by the pro rata prepayment.

(2) *Definition of pro rata prepayment.* For purposes of paragraph (f)(1) of this section, a pro rata prepayment is a payment on a debt instrument made prior to maturity that—

(i) Is not made pursuant to the instrument's payment schedule (including a payment schedule determined under § 1.1272-1(c)); and

(ii) Results in a substantially pro rata reduction of each payment remaining to be paid on the instrument.

(g) *Anti-abuse rule—(1) In general.* If a principal purpose in structuring a debt

instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (g) applies to a debt instrument that provides for a contingent payment, the Commissioner can treat the contingency as if it were a separate position. See also § 1.988-2(b)(18) for debt instruments with payments denominated in (or determined by reference to) a currency other than the taxpayer's functional currency.

(2) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. In the case of a contingent payment debt instrument, another significant fact is whether the result is obtainable without the application of § 1.1275-4 and any related provisions (e.g., if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (g):

Example 1. A issues a current-pay, increasing-rate note that provides for an early call option. Although the option is deemed exercised on the call date under § 1.1272-1(c)(5), the option is not expected to be exercised by A. In addition, a principal purpose of including the option in the terms of the note is to limit the amount of interest income includible by the holder in the period prior to the call date by virtue of the option rules in § 1.1272-1(c)(5). Moreover, the application of the option rules is expected to substantially reduce the present value of the holder's tax liability. Based on these facts, the application of § 1.1272-1(c)(5) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the regulations (in whole or in part) to the note without regard to § 1.1272-1(c)(5).

Example 2. C, a foreign corporation not subject to U.S. taxation, issues to a U.S. holder a debt instrument that provides for a contingent payment. The debt instrument is issued for cash and is subject to the noncontingent bond method in § 1.1275-4(b). Six months after issuance, C and the holder modify the debt instrument so that there is a deemed reissuance of the instrument under section 1001. The new debt instrument is subject to the rules of § 1.1275-4(c) rather than § 1.1275-4(b). The application of § 1.1275-4(c) is expected to substantially reduce the present value of the holder's tax liability as compared to the application of § 1.1275-4(b). In addition, a principal purpose of the modification is to substantially reduce the present value of the holder's tax liability through the application of § 1.1275-4(c). Based on these facts, the application of § 1.1275-4(c) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the noncontingent bond method to the modified debt instrument.

Example 3. D issues a convertible debt instrument rather than an economically equivalent investment unit consisting of a debt instrument and a warrant. The convertible debt instrument is issued at par and provides for annual payments of interest. D issues the convertible debt instrument rather than the investment unit so that the debt instrument would not have OID. See § 1.1273-2(j). In general, this is a reasonable result in light of the purposes of the applicable statutes. Therefore, the Commissioner generally will not use the authority under this paragraph (g) to depart from the application of § 1.1273-2(j) in this case.

(4) *Effective date.* This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

(h) *Remote and incidental contingencies—(1) In general.* This paragraph (h) applies to a debt instrument if one or more payments on the instrument are subject to either a remote or incidental contingency. Whether a contingency is remote or incidental is determined as of the issue date of the debt instrument, including any date there is a deemed reissuance of the debt instrument under paragraph (h)(6) (ii) or (j) of this section or § 1.1272-1(c)(6). Except as otherwise provided, the treatment of the contingency under this paragraph (h) applies for all purposes of sections 163(e) (other than sections 163(e)(5)) and 1271 through 1275 and the regulations

thereunder. For purposes of this paragraph (h), the possibility of impairment of a payment by insolvency, default, or similar circumstances is not a contingency.

(2) *Remote contingencies.* A contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur.

(3) *Incidental contingencies—(i) Contingency relating to amount.* A contingency relating to the amount of a payment is incidental if, under all reasonably expected market conditions, the potential amount of the payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(i), the payment is ignored until the payment is made. However, see paragraph (h)(6)(i)(B) of this section for the treatment of the debt instrument if a change in circumstances occurs prior to the date the payment is made.

(ii) *Contingency relating to time.* A contingency relating to the timing of a payment is incidental if, under all reasonably expected market conditions, the potential difference in the timing of the payment (from the earliest date to the latest date) is insignificant. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(ii), the payment is treated as made on the earliest date that the payment could be made pursuant to the contingency. If the payment is not made on this date, a taxpayer makes appropriate adjustments to take into account the delay in payment. However, see paragraph (h)(6)(i)(C) of this section for the treatment of the debt instrument if the delay is not insignificant.

(4) *Aggregation rule.* For purposes of paragraph (h)(2) of this section, if a debt instrument provides for multiple contingencies each of which has a remote likelihood of occurring but, when

all of the contingencies are considered together, there is a greater than remote likelihood that at least one of the contingencies will occur, none of the contingencies is treated as a remote contingency. For purposes of paragraph (h)(3)(i) of this section, if a debt instrument provides for multiple contingencies each of which is incidental but the potential total amount of all of the payments subject to the contingencies is not, under reasonably expected market conditions, insignificant relative to the total expected amount of the remaining payments on the debt instrument, none of the contingencies is treated as incidental.

(5) *Consistency rule.* For purposes of paragraphs (h) (2) and (3) of this section, the issuer's determination that a contingency is either remote or incidental is binding on all holders. However, the issuer's determination is not binding on a holder that explicitly discloses that its determination is different from the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed Federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See § 1.1275-2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(6) *Subsequent adjustments—(i) Applicability.* This paragraph (h)(6) applies to a debt instrument when there is a change in circumstances. For purposes of the preceding sentence, there is a change in circumstances if—

(A) A remote contingency actually occurs or does not occur, contrary to the assumption made in paragraph (h)(2) of this section;

(B) A payment subject to an incidental contingency described in paragraph (h)(3)(i) of this section becomes fixed in an amount that is not insignificant relative to the total expected amount of the remaining payments on the debt instrument; or

(C) A payment subject to an incidental contingency described in paragraph (h)(3)(ii) of this section becomes fixed such that the difference between the assumed payment date and the due date of the payment is not insignificant.

(ii) *In general.* If a change in circumstances occurs, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to the instrument's adjusted issue price on that date.

(iii) *Contingent payment debt instruments.* Notwithstanding paragraph (h)(6)(ii) of this section, in the case of a contingent payment debt instrument subject to §1.1275-4, if a change in circumstances occurs, no retirement or reissuance is treated as occurring, but any payment that is fixed as a result of the change in circumstances is governed by the rules in §1.1275-4 that apply when the amount of a contingent payment becomes fixed.

(7) *Effective date.* This paragraph (h) applies to debt instruments issued on or after August 13, 1996.

(i) [Reserved]

(j) *Treatment of certain modifications.* If the terms of a debt instrument are modified to defer one or more payments, and the modification does not cause an exchange under section 1001, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date. This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

(k) *Reopenings*—(1) *In general.* Notwithstanding §1.1275-1(f), additional debt instruments issued in a qualified reopening are part of the same issue as the original debt instruments. As a result, the additional debt instruments have the same issue date, the same issue price, and (with respect to holders) the same adjusted issue price as the original debt instruments.

(2) *Definitions*—(i) *Original debt instruments.* Original debt instruments are debt instruments comprising any single issue of outstanding debt instruments. For purposes of determining whether a particular reopening is a qualified reopening, debt instruments issued in prior qualified reopenings are treated as original debt instruments and debt instruments issued in the particular reopening are not so treated.

(ii) *Additional debt instruments.* Additional debt instruments are debt instruments that, without the application of this paragraph (k)—

(A) Are part of a single issue of debt instruments;

(B) Are not part of the same issue as the original debt instruments; and

(C) Have terms that are in all respects identical to the terms of the original debt instruments as of the reopening date.

(iii) *Reopening date.* The reopening date is the issue date of the additional debt instruments (determined without the application of this paragraph (k)).

(iv) *Announcement date.* The announcement date is the later of seven days before the date on which the price of the additional debt instruments is established or the date on which the issuer's intent to reopen a security is publicly announced through one or more media, including an announcement reported on the standard electronic news services used by security broker-dealers (for example, Reuters, Telerate, or Bloomberg).

(3) *Qualified reopening*—(i) *Definition.* A qualified reopening is a reopening of original debt instruments that is described in paragraph (k)(3)(ii), (k)(3)(iii), (k)(3)(iv), or (k)(3)(v) of this section. In addition, see paragraph (d)(2) of this section to determine if a reopening of Treasury securities is a qualified reopening.

(ii) *Reopening within six months.* A reopening is described in this paragraph (k)(3)(ii) if—

(A) The original debt instruments are publicly traded (within the meaning of §1.1273-2(f)) as of the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date);

(B) The reopening date of the additional debt instruments is not more than six months after the issue date of the original debt instruments; and

(C) On the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the original debt instruments (based on their fair market value) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued

§ 1.1275-3

26 CFR Ch. I (4-1-14 Edition)

with no more than a de minimis amount of OID, the coupon rate).

(iii) *Reopening with de minimis OID.* A reopening (including a reopening of Treasury securities) is described in this paragraph (k)(3)(iii) if—

(A) The original debt instruments are publicly traded (within the meaning of § 1.1273-2(f)) as of the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date); and

(B) The additional debt instruments are issued with no more than a de minimis amount of OID (determined without the application of this paragraph (k)).

(iv) *Non-publicly traded debt issued for cash.* A reopening is described in this paragraph (k)(3)(iv) if the additional debt instruments are issued for cash to persons unrelated to the issuer (as determined under section 267(b) or 707(b)) for an arm's length price and either the requirements in paragraphs (k)(3)(ii)(B) and (k)(3)(ii)(C) of this section for a reopening within six months are satisfied or the requirements in paragraph (k)(3)(iii)(B) of this section for a reopening with de minimis OID are satisfied. For purposes of paragraph (k)(3)(ii)(C) of this section, the yield test is satisfied if, on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the additional debt instruments (based on their cash purchase price) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a de minimis amount of OID, the coupon rate).

(v) *100 Percent yield test for reopening after six months.* A reopening is described in this paragraph (k)(3)(v) if the additional debt instruments are issued more than six months after the issue date of the original debt instruments and either the requirements in paragraphs (k)(3)(ii)(A) and (k)(3)(ii)(C) of this section are satisfied or the additional debt instruments are issued for cash to persons unrelated to the issuer (as determined under section 267(b) or 707(b)) for an arm's length price and the requirements in paragraph (k)(3)(ii)(C) of this section are satisfied.

For purposes of the preceding sentence, the yield test in paragraph (k)(3)(ii)(C) of this section is satisfied if, on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the additional debt instruments (based on their fair market value or cash purchase price, whichever is applicable) is not more than 100 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a de minimis amount of OID, the coupon rate).

(vi) *Exceptions.* This paragraph (k)(3) does not apply to a reopening of tax-exempt obligations (as defined in section 1275(a)(3)) or contingent payment debt instruments (within the meaning of § 1.1275-4).

(4) *Issuer's treatment of a qualified reopening.* See § 1.163-7(e) for the issuer's treatment of the debt instruments that are part of a qualified reopening.

(5) *Effective/applicability dates—*(i) Except as provided in paragraph (k)(5)(ii) of this section, this paragraph (k) applies to debt instruments that are part of a reopening if the reopening date is on or after March 13, 2001.

(ii) Paragraphs (k)(3)(ii)(A), (k)(3)(iii)(A), (k)(3)(iv) and (k)(3)(v) of this section apply to debt instruments that are part of a reopening if the reopening date is on or after September 13, 2012.

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§ 1.1275-3 OID information reporting requirements.

(a) *In general.* This section provides legending and information reporting requirements intended to facilitate the reporting of OID.

(b) *Information required to be set forth on face of debt instruments that are not publicly offered—*(1) *In general.* Except as provided in paragraph (b)(4) or paragraph (d) of this section, this paragraph (b) applies to any debt instrument that is not publicly offered (within the meaning of § 1.1275-1(h)), is issued in physical form, and has OID.