



1985

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Recommended Citation

Christine Dentino & Jeffrey B. Harris, Section 1274—The Application of the OID Provisions to Debt Instruments Issued for Property, 9 REV. OF TAX'N OF INDIVIDUALS 315 (1985)

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Section 1274—The Application of the OID Provisions to Debt Instruments Issued for Property

JEFFREY B. HARRIS * AND CHRISTINE DENTINO **

The Tax Reform Act of 1984 made substantial revisions to the original issue discount provisions of the Internal Revenue Code. The most significant change to the OID rules is the effect it will have on debt instruments given in consideration for the sale or exchange of property. This article explains and analyzes the new OID rules with respect to property transfers and provides the practitioner with a methodology for identifying transactions that may be subject to the recently enacted OID provisions.

Change in the OID Rules

Prior to the Tax Reform Act of 1984 (TRA '84), interest payments made on debt obligations given in consideration for the purchase of property were included in income by the seller and deducted by the buyer in a manner consistent with their method of accounting. Additionally, the amount of interest to be paid by the purchaser in a deferred payment transaction was subject to Section 483. Section 483 acted to recharacterize a portion of principal as unstated interest as payments were made on the debt obligation. The safe-harbor rate was 9 percent per year simple interest.

The purpose behind the new original issue discount (OID) provisions is to prevent certain distortions caused through the manipulation of prior law. For example, if an accrual-method borrower-buyer and a cash-method lender-seller agreed to the accrual of interest payments, the borrower could deduct the deferred interest prior to the inclusion into income of the interest payments by the lender. The result was a deferral of income tax on the interest income and a corresponding acceleration of interest expense deductions. The problem was magnified if the parties

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computed interest using a method that did not reflect the economic accrual or compounding of interest¹ such as the straight-line or simple interest methods. Moreover, in deferred payment sales transactions, the parties could manipulate the principal amount by understating the interest portion of the transaction. By overstating the purchase price and understating the interest rate, the seller could convert ordinary interest income into capital gain and the buyer could claim excessive cost recovery deductions and investment tax credits.²

Section 483 proved to be an inadequate tool in preventing or deterring these practices. The Section 483 interest rates did not keep up with the market interest rates, the use of simple interest as a test for adequate interest ignored the "compounding" element on unpaid interest, and a single rate of interest for all debt obligations, regardless of length of time to maturity, ignored the reality that lenders require different interest rates depending on the term of a loan.³ In addition, the scope of transactions subject to the old OID provisions was limited.

Method of Change

To cure the above abuses, TRA '84 extended the OID provisions to debt obligations issued by individuals and to debt obligations issued for non-publicly traded property. The new treatment of such debt instruments issued for property is a combination of many of the principles and computations found in former Sections 1232A⁴ and 483⁵ and a host of new definitions and special rules.

If the OID rules apply to a deferred payment transaction, the OID is included in the income of the holder of a debt obligation throughout the life of the obligation and a corresponding amount is deductible by the issuer,⁶ regardless of the method of accounting of the holder or issuer.

¹ H.R. Rep. No. 452, Pt. II, 98th Cong., 2d Sess. 1242-1244 (1984) (hereinafter cited as House Report); S. Rep. No. 169, 98th Cong., 2d Sess. at 250-251 (1984) (hereinafter cited as Senate Report); Rev. Rul. 83-84, 1983-1 C.B. 97 (prohibiting deduction of interest greater than economic accrual).

² See generally Canellos & Kleinbard, "The Miracle of Compound Interest: Interest Deferral and Discount After 1982," 38 Tax L. Rev. 565 (1983). Of course, the buyer's interest deductions would be reduced.

³ House Report, note 1 *supra*, at 1245; Senate Report, note 1 *supra*, at 253.
⁴ See Pub. L. No. 98-369 § 42, 98 Stat. 494 at 356, (repealing I.R.C. § 1232(A)).
⁵ New § 1271, testing the retirement, sale, or other disposition of other debt instruments, incorporates the provisions of former § 1232(a); new § 1272, dealing with the inclusion of OID in income, encompasses the provisions of former § 1232A; and new § 1273, providing for the calculation of OID, replaces former § 1232(b). Bush, "Analyzing the Far-Reaching Changes for Debt Instruments Under the New Tax Law," 61 J. Tax'n 150 (1984).

⁶ I.R.C. § 163(f).

The portion of the OID attributable to any given period is computed using a formula that attempts to reflect the economic accrual of interest.

Under the new OID provisions, OID exists if interest on a loan is allowed to accrue or if the amount of the debt obligation exceeds the fair market value of the property.⁷ In order to avoid valuation problems,⁸ Congress enacted a test rate equal to 110 percent of the "applicable federal rate" to test the adequacy of the interest element in a transaction. If the interest element is found to be inadequate, the principal amount of an instrument will be the present value of all payments due under the instrument using a discount rate equal to 120 percent of the applicable federal rate. The applicable federal rate is based on the average yield for marketable obligations of the United States government and will be redetermined at six-month intervals. The federal rate will also reflect the length of the obligation: short term, midterm, and long term. Once the interest and principal elements of a deferred payment transaction have been identified, the OID will be treated as interest for all purposes of the Code, including, for example, Sections 163, 189, 265, and 543. Similarly, the principal amount will be treated as the cost of the property for all purposes of the Code, including Sections 46, 168, 453, 1001, and 1012.⁹

Determining the Applicability of Section 1274

The OID rules apply to any debt instrument¹⁰ given in consideration for the sale or exchange of property¹¹ if (1) some or all of the payments due under the debt instrument are due more than six months after the date of the sale or exchange and (2) the stated redemption price at maturity exceeds, where there is adequate stated interest, the principal amount, or, in any other case, the testing amount.¹² The stated redemp-

⁷ The accrued portion of the interest and/or the excess of the amount of the debt obligation over the fair market value of the property is deemed to represent OID.

⁸ House Report, note 1 *supra*, at 1243 n. 5; Senate Report, note 1 *supra*, at 251 n. 3.

⁹ House Report, note 1 *supra*, at 1247-1249; Senate Report, note 1 *supra*, at 256.

¹⁰ The term "debt instrument" means a bond, debenture, note, or certificate or other evidence of indebtedness, but does not include annuity contracts to which § 72 applies. I.R.C. § 1274(a)(11).

¹¹ "Property" includes all tangible and intangible assets of any sort except money. House Report, note 1 *supra*, at 1246. The Senate Report defines money as "United States currency and checks." Senate Report, note 1 *supra*, at 253.

¹² I.R.C. § 1274(c)(1). Generally, the 1984 amendments to the OID provisions apply in tax years ending after July 18, 1984. Section 1272, however, is not applicable to any obligations issued prior to December 31, 1984 that are not a capital asset in the hands of the taxpayer. Debt instruments subject to § 1274 are obligations received in

tion price at maturity is the amount payable at the maturity date including interest and other amounts payable at that time unless such interest is determined on a fixed rate and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument.¹⁵ Interest is considered unconditionally payable if a failure to pay results in consequences to the borrower that are typical in normal commercial lending transactions.¹⁴

A debt instrument has adequate stated interest if the stated principal amount for such debt instrument is less than or equal to the testing amount.¹⁵ The "testing amount" equals the sum of the present values of all payments due under the debt instrument (the imputed principal amount) using a discount rate equal to 110 percent of the applicable federal rate.¹⁶ Thus, if the rate of currently payable interest is equal to or in excess of 110 percent of the applicable federal rate, there is adequate stated interest.

After the adequacy of stated interest is determined, it is necessary to compare the stated redemption price at maturity with the stated principal amount or the testing amount, whichever is applicable. If the stated redemption price at maturity exceeds the applicable amount, Section 1274 governs the treatment of the debt instrument. Accordingly, unless a specific exception applies to the transaction,¹⁷ the OID

exchange for property sold or exchanged after December 31, 1984, unless the sale or exchange was pursuant to a written contract that was binding on March 1, 1984. Finally, § 1275(c), dealing with the information requirements, is effective on August 17, 1984.

¹⁴ I.R.C. § 1273(a)(2).

¹⁵ Senate Report, note 1 *supra*, at 254-255. Acceleration of interest (and principal) would be considered typical in normal commercial transactions. If principal reductions or interest payments are made at irregular intervals, the stated redemption price at maturity may have to be adjusted.

¹⁶ Assume, for example, that a note in the amount of \$1 million was issued with adequate stated interest payable currently and 3 percent interest accrued until maturity. The note is amortized over thirty years but matures in ten years. The stated redemption price at maturity would equal the beginning principal balance plus accrued interest and less principal payments on the note. If, however, a principal payment of \$750,000 were due in nine years and the balance of the principal and accrued interest were payable at maturity, some adjustment to the stated redemption price at maturity would have to be made to assure treatment consistent with the new law.

¹⁷ I.R.C. § 1274(c)(2).

¹⁸ I.R.C. § 1274(c)(3). No OID will be deemed to exist in situations when a debt instrument issued for nontraded property bears interest, unconditionally payable at least annually, at a variable rate, provided the stated rate is a floating note, adjusted at no more than six-month intervals, at least equal to 110 percent of the federal short-term rate. H.R. Rep. No. 861, 98th Cong., 2d Sess. 889 (1984) (hereinafter cited as Conference Report).

¹⁹ See text accompanying notes 76-90 *infra*.

rules will apply if an interest rate of less than 110 percent of the applicable federal rate is provided for in the debt instrument and the interest is payable unconditionally at the stated rate on an annual basis. When the OID provisions do not apply, the parties will report the transaction according to their agreement and methods of accounting.¹⁸

The types of dispositions to which Section 1274 may apply include all sales or exchanges of property in which a debt instrument is given as consideration. Section 1274 must be considered not only in the typical sale or exchange transaction but also in transactions involving the transfer of property to a controlled corporation under Section 351, the like-kind exchange of property under Section 1031, and the receipt of boot not treated as a dividend in a corporate reorganization under Section 356. In addition, the Code contains many statutory sale or exchange provisions requiring certain transactions to be treated as sales or exchanges whether or not they are encompassed in the ordinary meaning of those terms.

Examples of such transactions to which Section 1274 may apply include the cancellation of a lease by a lessee under Section 1241, the transfer of all the substantial rights to a patent under Section 1235,¹⁹ and certain distributions by a partnership to a partner under Section 731. In the corporate area, transactions that might not otherwise qualify as sales or exchanges include partial liquidations and redemptions under Sections 302 and 303, complete liquidations under Section 331 (a), certain stock purchases treated as asset acquisitions under Section 338, and distributions in excess of earnings and profits and basis under Section 301(c)(3).²⁰ Of course, the above list of areas to which Section 1274 may apply is not meant to be exhaustive. It is important to note, however, that any disposition that does not meet the technical definition of a sale or exchange²¹ would not fall under the umbrella of Section 1274. For example, compensation for the destruction of property has been held not to constitute a sale or exchange²² and should not be subject to the OID provisions.

¹⁸ House Report, note 1 *supra*, at 1247; Senate Report, note 1 *supra*, at 255.

¹⁹ In the case of a transfer of patents under § 1235(a), § 1274 does not apply to any amount contingent on the productivity, use, or disposition of the property transferred. I.R.C. § 1274(c)(4)(E).

²⁰ See I.R.C. § 1275(a)(5). See generally TRA '84, Pub. L. No. 98-369, § 61(c)(2), 98 Stat. 494, 581 (1984).

²¹ *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941).

²² *Id.* at 249.

Original Issue Discount

Stated Redemption Price at Maturity — Issue Price = OID

Section 1273(a)(1) defines OID on a debt instrument as the excess, if any, of the stated redemption price at maturity over the issue price.²³ As previously stated, the stated redemption price at maturity is the total amount payable at maturity including any interest, unless the interest is based on a fixed rate and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument.²⁴

The term "issue price" has various definitions. The applicable definition is dependent on the type of transaction in which the note is issued. With respect to debt instruments that are either not publicly traded or not issued for property,²⁵ the definition of issue price is relatively straightforward. In the case of *publicly offered* debt instruments *not issued for property*, the issue price is the initial offering price²⁶ to the public at which price a substantial amount of such debt instruments were sold.²⁷ In the case of debt instruments *not issued for property* and *not publicly offered*, the issue price of each such instrument is the price paid by the first buyer²⁸ of such debt instrument.²⁹ When a debt instrument is *issued for property*, and such instrument is part of an issue a portion of which is traded on an established securities market or is issued for stock or securities that are traded on an established securities market, the issue price of such debt instrument is the fair market value of such property.³⁰

²³ I.R.C. § 1273(a)(3) provides that if OID is less than one-quarter of one percent of the stated redemption price at maturity multiplied by the number of complete years to maturity, then the OID shall be treated as zero.

²⁴ I.R.C. § 1273(a)(2); see note 13 *supra*.

²⁵ For purposes of the definition of issue price under § 1273, property includes services and the right to use property but such term does not include money. I.R.C. § 1273(b)(5).

²⁶ The special rules for determining issue price under § 1273 provide that "the terms 'initial offering price' and 'price paid by the first buyer' include the aggregate payments made by the purchaser under the purchase agreement, including modifications." I.R.C. § 1273(c)(3).

²⁷ I.R.C. § 1273(b)(1). For purposes of § 1273(b)(1), the phrase "date of original issue" means the date on which the issue was first issued to the public. I.R.C. § 1275(a)(2)(A).

²⁸ See note 26 *supra*.

²⁹ I.R.C. § 1273(b)(2). For purposes of § 1273(b)(2), the phrase "date of original issue" means the date on which the debt instrument was sold by the issuer. I.R.C. § 1275(a)(2)(B).

³⁰ I.R.C. § 1273(b)(3). For purposes of *publicly traded* debt instruments under § 1273(b)(3), the phrase "date of original issue" means the date on which the issue

In the case of debt instruments *issued for property* other than debt instruments that are publicly traded or debt instruments that are issued for publicly traded property, the issue price generally is determined under Section 1274.³¹ In all other cases, the issue price of a debt instrument that is issued for property is the stated redemption price at maturity,³² and there is, therefore, no OID on such debt instruments.

If Section 1274 applies to a debt instrument, the determination of issue price is dependent on whether there is adequate stated interest on the debt instrument.³³ Section 1274(a) provides that the issue price shall be (1) where there is adequate stated interest, the stated principal amount, or (2) in any other case, the imputed principal amount. The adequacy of the stated interest already has been determined in testing whether the provisions of Section 1274 are applicable to the transaction. Generally, there is adequate stated interest if the rate of currently payable interest is at least 110 percent of the applicable federal rate.³⁴ If interest is adequately stated, the issue price equals the stated principal amount of the debt. In any other case, the issue price is the imputed principal amount.³⁵ The imputed principal amount is the present value of all payments due under such debt instrument.³⁶ The present value is determined as of the date of the sale or exchange and by using a discount rate equal to 120 percent of the applicable federal rate, compounded semiannually.³⁷ Thus, if the test rate of 110 percent of the applicable federal rate is not met, an interest rate of 120 percent of the applicable federal rate is imputed. Furthermore, if the stated interest rate is 110 percent of the applicable federal rate but some or all of the in-

was first issued to the public. I.R.C. § 1275(a)(2)(A). For purposes of *nonpublicly traded* debt instruments issued for stock or securities, which are traded on an established securities market under § 1273(b)(3), the phrase "date of original issue" means the date on which the debt instrument was issued in a sale or exchange. I.R.C. § 1275(a)(2)(C).

³¹ I.R.C. §§ 1274(c)(1), 1274(c)(4)(D). For purposes of § 1274, the phrase "date of original issue" means the date on which the debt instrument was issued in a sale or exchange. I.R.C. § 1275(a)(2)(C).

³² I.R.C. § 1273(b)(4). If a debt instrument is issued for another debt instrument pursuant to a plan of reorganization and the issue price of the new debt instrument is less than the adjusted issue price of the old debt instrument, the issue price of the new debt instrument is the amount of the adjusted issue price of the old. I.R.C. § 1275(a)(4). Generally, the adjusted issue price of the old debt is its issue price, increased by the portion of OID previously included in gross income.

³³ I.R.C. § 1274(a).

³⁴ See text accompanying notes 15-17 *supra*.

³⁵ I.R.C. § 1274(a)(2).

³⁶ I.R.C. § 1274(b)(1).

³⁷ I.R.C. § 1274(b)(2).

interest is not currently payable, interest will be imputed at the stated rate rather than at 120 percent of the applicable federal rate.³⁸

Applicable Federal Rate

As provided in Section 1274(d), the "applicable federal rate" used to test the adequacy of stated interest is defined in Section 1274(d). A short-term rate applies to debt instruments with a term not over three years, a midterm rate applies to a debt instrument with a term of over three years but not over nine years, and a long-term rate applies to a debt with a term of over nine years. The applicable rate for each category is based on the average yield for marketable United States obligations with a comparable maturity.³⁹ The federal rate for each category will be redetermined at six-month intervals. For the six-month period beginning on January 1 of any year, the applicable federal rate will be the average yield during the six-month period ending on September 30 of the preceding year and will be determined by the Secretary on or before October 15 of that year. Correspondingly, the applicable federal rate during the six-month period beginning on July 1 of any year will be determined on or before April 15 of that year. For the period of July 1, 1985 to December 31, 1985, the short-term, midterm, and long-term rates are, respectively, 10.15 percent, 11.45 percent, and 11.73 percent compounded semiannually.⁴⁰ The federal rate applicable to a debt instrument is determined on the day the written contract to sell or exchange property is binding.⁴¹ In addition, the term of the debt instrument will take into account any options to renew or extend the instrument.⁴²

Potentially Abusive Situations

For purposes of computing the issue price in the case of any potentially abusive transaction, the imputed principal amount of the debt instrument equals the fair market value of the property with adjustments for any other consideration involved in the transaction.⁴³ This pro-

vision allows the Service to examine transactions on an individual basis and to restructure abusive transactions to reflect economic reality. The difference between the stated redemption price at maturity and the fair market value of the property is an exact measurement of OID with respect to a particular transaction. Valuation of property, of course, is not an exact science.

Section 1274(b)(3) defines potentially abusive situations to include tax shelters and any other situation having a potential for tax avoidance. For purposes of Section 1274, the term "tax shelter" is defined in Section 6661(b)(2)(C)(ii) to mean "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." Tax shelters generally are transactions structured with little, or no, motive for the realization of economic gain, and use many of the tax benefits provided in the Code in a manner inconsistent with congressional intent.⁴⁴ Section 1274 also gives authority to the Secretary to include other situations which, by reason of recent sales transactions, nonrecourse financing, financing with a term in excess of the economic life of the property, and any other circumstances, have the potential for tax avoidance.

One example of a transaction where the imputed principal amount of a debt instrument should be redetermined as the fair market value of the property under the abuse provisions of Section 1274(b)(3) is an agreement in which the principal amount of an obligation is less than the fair market value of the property. Taxpayers may intentionally overstate the OID when the property involved is nondepreciable or the seller-lender is not subject to tax on the interest income.⁴⁵ Conversely, if the property is depreciable, the principal amount of a nonrecourse obligation may be inflated and even exceed the fair market value of the property. A recent purchase by the seller at a significantly lower price, without substantial interim improvements, often evidences such an abuse. In this situation, the purported debt obligation may be partially or wholly disregarded under general tax principles.⁴⁶

³⁸ Prop. Reg. § 1.6661-5(b).

³⁹ Conference Report, note 16 *supra*, at 888; see Senate Report, note 1 *supra*, at 255.

⁴⁰ L.R.C. § 1274(d)(1)(D). For example, the yield on bonds, the face amount of which may be used to satisfy federal estate tax obligations (so-called flower bonds), would not be taken into account. Senate Report, note 1 *supra*, at 1246.

⁴¹ Rev. Rul. 85-51, 1985-17 I.R.B. 7.

⁴² L.R.C. § 1274(d)(2).

⁴³ L.R.C. § 1274(d)(3).

⁴⁴ L.R.C. § 1274(b)(3).

⁴⁵ L.R.C. § 1274(b)(3).

⁴⁶ Prop. Reg. § 1.6661-5(b).

⁴⁷ Conference Report, note 16 *supra*, at 888; see Senate Report, note 1 *supra*, at 255.

⁴⁸ House Report, note 1 *supra*, at 1247; Senate Report, note 1 *supra*, at 255.

When the principal amount of an obligation is limited under the fair market value rule, the principal amounts in excess of the fair market value of the property generally will be treated as contingent purchase price amounts with respect to the property, and will give rise to additional tax basis to the purchaser at the time such amounts actually are paid to the seller. Senate Report, note 1 *supra*, at 256; Estate of Franklin v. Comm'r,

In addition to the potentially abusive situations described in Section 1274(b)(3), Congress was concerned with any transaction devised to circumvent the statute. For example, a seller cannot make a low-interest loan to the buyer with the buyer using the loan proceeds to purchase the property from the seller and thereby avoid the application of Section 1274.⁴⁷ Furthermore, Section 1275(d) gives the Secretary power to prescribe regulations to modify the OID rules when, by reason of varying interest rates, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, or other circumstances, the purpose of the OID provisions otherwise could not be carried out.

In transactions to which the OID provisions are applicable, the stated redemption price at maturity minus the issue price of a debt instrument equals the total of OID with respect to such debt instrument that will be included in income by the obligee⁴⁸ and deducted by the obligor⁴⁹ over the term of the debt instrument. Section 1272 of the Code allocates the OID over the life of the obligation in a manner intended to reflect an economic accrual of the interest. One way to conceptualize the economic accrual method is to view the borrower as borrowing an additional amount in each accrual period to meet the compounding interest obligation.

Inclusion of OID in Income

Section 1272 provides that the holder of any debt instrument having OID shall include in gross income an amount equal to the sum of the daily portions of the OID for each day during the taxable year on which such holder held such debt instrument.⁵⁰

The daily portion of the OID is determined by allocating to each day in any accrual period its ratable portion of the increase in the adjusted issue price of the debt instrument during the accrual period.⁵¹ The increase in adjusted issue price for any accrual period equals (AIP × YTM) — CPI. "AIP" is the adjusted issue price of the debt instrument at the beginning of such accrual period.⁵² The adjusted issue price at the beginning of an accrual period is the issue price of such debt

64 T.C. 752 (1975), *aff'd*, 544 F.2d 1045 (9th Cir. 1976); Rev. Rul. 76-111, 1976-1 C.B. 214.

⁴⁷ Conference Report, note 16 *supra*, at 888.

⁴⁸ I.R.C. § 1272(a)(1).

⁴⁹ I.R.C. § 163(e)(1).

⁵⁰ I.R.C. § 1272(a)(1).

⁵¹ I.R.C. § 1272(a)(3).

⁵² I.R.C. § 1272(a)(3)(A)(i).

instrument plus any amounts previously taken into income under the OID provisions.⁵³ "YTM" is the yield to maturity of the debt instrument.⁵⁴ "CPI" is the currently payable interest on the debt instrument during the accrual period.⁵⁵ In any full accrual period for a taxable year, the entire amount of the increase in the adjusted issue price will constitute OID in that taxable year. If only a portion of an accrual period falls within a taxable year, the OID, and thus the increase in adjusted issue price, will be prorated on a daily basis with respect to the accrual period.⁵⁶ The term "accrual period" means "a six-month period (or shorter period from the date of original issue of the debt instrument) which ends on a day in the calendar year corresponding to the maturity date of the debt instrument or the date six months before such maturity date."⁵⁷

A few examples of the computation of the daily portions of OID should aid the practitioner in better understanding a relatively complex set of rules. Assume that a note is issued in exchange for property on January 1, 1986 with a face value of \$1 million. The note bears 14.2 percent simple interest with principal (\$1,000,000) and interest (total = \$710,000) payable in five years. The YTM is calculated to be 11.0229 percent on a semiannual basis. The OID for the term of the note would be calculated as follows⁵⁸:

	Accrual Period (End)		
	6/30/86	12/31/86	6/30/87
AIP	\$1,000,000.00	\$1,055,114.50	\$1,113,266.61
YTM (½)	.0551145	.0551145	.0551145
Total Interest	\$ 55,114.50	\$ 58,152.11	\$ 61,357.13
Less CPI	—0—	—0—	—0—
OID	\$ 55,114.50	\$ 58,152.11	\$ 61,357.13

⁵³ I.R.C. § 1272(a)(4).

⁵⁴ The Finance Committee Report on TEFRA provided an algebraic equation for computing a bond's yield to maturity. See S. Rep. No. 494, 97th Cong., 2d Sess. 210 (1982).

⁵⁵ I.R.C. § 1272(a)(3)(A)(ii).

⁵⁶ I.R.C. § 1272(a)(3). There is an exception to this rule. "[I]n the case of any purchase after its original issue of a debt instrument . . . the daily portion for any day shall be reduced by an amount equal to the amount which would be the daily portion for such day . . . multiplied by the fraction determined under [§ 1272(a)(6)(B)]." I.R.C. § 1272(a)(6).

⁵⁷ I.R.C. § 1272(a)(5).

⁵⁸ It is assumed, for purposes of this example, that the YTM on the note is in excess of 110 percent of the applicable federal rate on the date issued. Thus, no adjustment of the issue price is required.

	Accrual Period (End)		
	12/31/87	6/30/88	12/31/88
AIP	\$1,174,623.74	\$1,239,362.54	\$1,307,669.39
YTM (1/2)	.0551145	.0551145	.0551145
Total interest	\$ 64,738.80	\$ 68,306.85	\$ 72,071.54
Less CPI	—0—	—0—	—0—
OID	\$ 64,738.80	\$ 68,306.85	\$ 72,071.54

	Accrual Period (End)		
	6/30/87	12/31/89	6/30/90
AIP	\$1,379,740.93	\$1,455,784.66	\$1,536,019.50
YTM (1/2)	.0551145	.0551145	.0551145
Total interest	\$ 76,043.73	\$ 80,234.84	\$ 84,656.95
Less CPI	—0—	—0—	—0—
OID	\$ 76,043.73	\$ 80,234.84	\$ 84,656.95

	Accrual Period (End)
	12/31/90
AIP	\$1,620,676.45
YTM (1/2)	.0551145
Total interest	\$ 89,322.77
Less CPI	—0—
OID	\$ 89,322.77
Total OID	\$ 709,999.22 ⁵⁹
Ending AIP	\$1,709,999.22

Not all debt obligations are issued at the first day of a taxpayer's taxable year. If, for example, the above described note were issued on February 1, 1986 and matured on February 1, 1991, the first fiscal year's OID would be computed as set forth below:

	Accrual Period (End)	
	7/31/86	1/31/87
AIP	\$1,000,000.00	\$1,055,144.50
YTM	.0551145	.0551145
Total interest	\$ 55,114.50	\$ 58,153.76
Less CPI	—0—	—0—
OID	\$ 55,114.50	\$ 58,153.76

⁵⁹ The YTM was calculated to the nearest 1/100,000 of a percent. Such rounding is responsible for the difference between the stated redemption price at maturity (\$1,710,000) and the ending AIP (\$1,709,999.22).

If, however, the taxpayer uses a calendar year taxable year, the August 1, 1986 to January 31, 1987 accrual period's OID will be included in the taxpayer's income by allocating to each day in such taxable year a ratable portion of the accrual period's OID.⁶⁰ Thus, the taxpayer would include \$55,114.50 plus \$43,566.12 ($(153/184 \times (58,153.76))$) as income for the calendar year. It is interesting to note that accrual periods are determined by counting *back*, in six-month intervals, from the maturity date of the debt instrument.⁶¹ Therefore, if the term of the debt instrument is not easily divisible by a six-month term, the *first* accrual period will be a "short accrual period."⁶²

Interest payable during an accrual period reduces the amount of OID included in income for each accrual period. In the example above, all interest was payable at maturity, and therefore, no such reduction of OID was allowed. A debt obligation that requires monthly principal payments will complicate the computation of OID. If the total of all principal payments during an accrual period were to reduce the AIP before application of the YTM to compute total interest for the period, the total interest for such period would be understated. Thus, any computation involving a debt instrument with principal payments will have to include an "average principal balance" component.

Assumed Debt Obligations

As provided in Section 1274(c), Section 1274 generally applies to debt instruments given in consideration for the sale or exchange of property. Since the passage of the 1984 Act, controversy has surrounded the application of the OID provisions to an existing debt instrument assumed or taken subject to by a purchaser of property.⁶³ The only reference in the statute to "assumed debt" is in Section 1275(d) which states, "The Secretary may prescribe regulations providing that where, by reason of . . . assumptions of debt instruments, or other circumstances, the tax treatment under this subpart (or section 163(e)) does not carry out the purposes of this subpart (or section 163(e)), such treatment shall be modified to the extent appropriate to carry out the purposes of this subpart (or section 163(e))." Although both the Senate Finance

⁶⁰ I.R.C. § 1272(a)(3).

⁶¹ I.R.C. § 1272(a)(5).

⁶² The "short accrual period" complicates the computation of the YTM.

⁶³ For purposes of this article, both "assumptions of a debt instrument" and "taking subject to a debt instrument" will be considered an "assumption of the instrument."

Committee Report and the House Ways and Means Committee Report were silent on this point, the Conference Committee Report states:

Finally, the conferees anticipate that the Commissioner will issue regulations, similar to the regulations under existing section 483, dealing with the tax consequences of debt obligations which are assumed or taken subject to, that is, the transfer of obligations to make or rights to receive deferred payments subject to the OID rules. The conferees intend that such rules apply not only to the assumption of deferred payment obligations, but also to assumptions of obligations to third-party lenders. These rules will apply to sales and exchanges after December 31, 1984, and therefore will apply to debt obligations that are assumed or taken subject to after that date even though such obligations were first issued prior to that date.⁶⁴

The authority and necessity for applying the OID provisions to assumed debt have long existed. Under general tax principles, whether a debt instrument is recourse or nonrecourse and whether the debt is assumed or taken subject to by the purchaser on the sale or exchange of property, the seller is treated as having received a benefit and buyer is treated as incurring a cost equal to the face value of the obligation.⁶⁵ Although the fair market value of a debt instrument (with an interest rate materially above or below the market interest rate at the time of the transaction) may not be equal to the face value of the obligation, the disparity is not reflected in the tax treatment of the debt instrument. The discount or premium, however, often is reflected in the purchase price of the property, and thereby influences the seller's amount realized and the buyer's basis in the property acquired. It is this type of recharacterization that Congress intended to prevent with the passage of the new OID provisions.⁶⁶

The question of whether assumed debt is subject to the OID provisions was addressed by the Imputed Interest Compromise.⁶⁷ The Compromise was passed to quiet the controversy over the new OID rules and the amendments to Section 483. With respect to assumptions of debt, the Compromise specifically provides that Sections 1274 and 483 will apply to debt obligations assumed or taken subject to by the

purchaser in connection with the sale or exchange of property.⁶⁸ It also excepts certain debt obligations assumed in transactions from the application of these sections. "Corrective" legislation almost certainly will expand the class of exemptions.

Generally, assumptions of loans issued before October 15, 1984 will be permanently exempt from Sections 1274 and 483 unless the terms and conditions of the debt instrument are modified in connection with the assumption or the transaction involves a sales price greater than \$100 million.⁶⁹ The Secretary was given authority to issue regulations as may be necessary to effect the purpose of the exception, including regulations governing tax-exempt obligations and government-subsidized loans.⁷⁰ The Secretary also was given authority to issue regulations exempting certain transactions if the exemption does not significantly reduce the tax liability of the purchaser by overstating the adjusted basis of the acquired asset.⁷¹ In addition, debt instruments assumed in connection with the acquisition of certain types of property are exempt from Sections 1274 and 483 if certain conditions are met. Generally, the assumption of loans in connection with principal residences, vacation homes, farms, and small business property will be permanently exempt from both sections.⁷²

If the above exceptions do not apply, Section 1274 will apply to the assumption of a debt obligation by the purchaser of property. The method of applying the new provisions, however, is unclear. As stated in the Conference Report, the conferees anticipate the issuance of regulations by the Treasury similar to the regulations under Section 483.⁷³ Regulations Section 1.483-1(f)(6) provides guidelines for the computation and treatment of unstated interest on the transfer of deferred payment obligations. Generally, if the purchaser of property assumes or takes subject to an existing debt instrument under which there is total unstated interest, the person who has the right to receive payment under the obligation is *not affected* and the transferee "steps into the shoes" of the transferor with respect to any interest deductions. However, a *separate determination must be made as to the application of Section 483*

⁶⁴ *Id.* § 2.

⁶⁵ Imputed Interest Compromise, 200 Daily Tax Rep. (BNA) J-1 (Oct. 16, 1984); Pub. L. No. 98-612, 98 Stat. 3184 (1984); see 199 Daily Tax Rep. (BNA) G-3 (Oct. 15, 1984).

⁶⁶ Pub. L. 98-612, note 67 *supra*, § 2(6)(C).

⁶⁷ *Id.* § 2(7)(D).

⁶⁸ *Id.* § 2(7)(A).

⁶⁹ Conference Report, note 16 *supra*, at 889.

⁶⁴ Conference Report, note 16 *supra*, at 889.

⁶⁵ *Crane v. Comm'r*, 331 U.S. 1 (1947); *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950), *cert. denied*.

⁶⁶ See note 2 *supra*.

⁶⁷ Pub. L. No. 98-612, 98 Stat. 3184 (1984).

to the contract between the transferor and the transferee.⁷⁴ For purposes of this separate determination, the amount of the obligation is treated as a payment at the time of transfer.⁷⁵

With modifications, the Section 483 regulations could adequately serve the purposes of the OID provisions. If a debt obligation under which OID exists is assumed, the person who has the right to receive payments under the debt instrument continues to include interest in income, unaffected by the transfer. If there is no OID, the mere transfer of the obligation will cause a redetermination of the applicability of Section 1274 to the origin parties.

With regard to the separate determination between the transferee and the transferor, Section 1274 should apply to the debt instrument assumed regardless of whether Section 1274 applied at the time the obligation originated. At the time of the assumption, the allocation of the purchase price between interest and principal is again at issue. Therefore, the transferee should not merely take the transferor's place as to any existing OID. A separate determination must be made as to the application of Section 1274, with the assumed obligation being treated as a debt obligation of the transferee, whether or not there is preexisting OID on the obligation. Furthermore, in applying Section 1274, all of the debt obligations between the transferor and the transferee, including the assumed obligation, should be tested in the aggregate using a yield-to-maturity approach.

Exceptions to OID

The OID sections contain numerous exceptions that remove many of the everyday transactions engaged in by taxpayers from the application of these complex provisions.⁷⁶ The exceptions to Section 1272 that deal with the current inclusion of OID in income include an exception for tax-exempt obligations,⁷⁷ United States savings bonds,⁷⁸ debt instruments with a fixed maturity date of not more than one year from the date of issue,⁷⁹ and obligations issued by natural persons prior to March 2, 1984.⁸⁰ Loans aggregating \$10,000 or less between natural persons

are exempt if the loan is not made in the course of a trade or business of the lender and does not have as one of its principal purposes the avoidance of any federal tax.⁸¹

Section 1274(c)(4) exempts from the OID provisions certain sales of property that are otherwise within the purview of Section 1274. The exceptions include the sale by an individual of a principal residence within the meaning of Section 1034,⁸² debt instruments described in Section 1273(b)(3) which are publicly traded or issued for publicly traded property,⁸³ sales of patents under Section 1235(a) to the extent payment is contingent upon the productivity, use or disposition of the patent,⁸⁴ and sales to which Section 483(f) applies (relating to certain land transfers between related individuals).⁸⁵ Debt instruments received by an individual, estate, testamentary trust, or certain small businesses in exchange for a farm⁸⁶ are also exempt if it can be determined at the time of the sale that the sale price cannot exceed \$1 million.⁸⁷ A further exemption is provided for a debt instrument received on the sale or exchange of property if the sum of the payments due under the instrument and under any other debt instruments received as consideration, including interest payments⁸⁸ plus the fair market value of any other consideration, does not exceed \$250,000.⁸⁹ Finally, certain obligors are not subject to the OID rules. Section 1275(b)(2) also exempts a cash-method obligor from the OID rules in the case of any debt instrument incurred in connection with the acquisition or carrying of property when the property will not be used substantially in a trade or business or in an investment activity. Section 1275(b)(1) exempts a borrower from the application of Sections 1274 and 483 when the instrument is given in consideration for the sale or exchange of personal

⁸¹ I.R.C. § 1272(a)(2)(E). A husband and wife are treated as one person. I.R.C. § 1272(a)(2)(E)(iii). In addition, § 1272 does not apply to any holder who has purchased the debt interest at a premium or which is a life insurance company to which § 811(b) applies. I.R.C. § 1272(c).

⁸² I.R.C. § 1274(c)(4)(B).

⁸³ I.R.C. § 1274(c)(4)(D).

⁸⁴ I.R.C. § 1274(c)(4)(E).

⁸⁵ I.R.C. § 1274(c)(4)(F).

⁸⁶ For the purposes of § 1274, the term "farm" includes stock, dairy, poultry, fruit, fur-bearing animal and truck farms, plantations, ranches, nurseries, ranges, greenhouses, or other similar structures used primarily for the raising of agricultural or horticultural commodities and orchards. See I.R.C. § 1274(c)(4)(A)(i), 6420(c)(2).

⁸⁷ I.R.C. § 1274(c)(4)(A).

⁸⁸ Senate Report, note 1 *supra*, at 257.

⁸⁹ I.R.C. § 1274(c)(4)(C).

⁷⁴ Reg. § 1.483-1(f)(6)(d).

⁷⁵ *Id.*

⁷⁶ See generally I.R.C. §§ 1272(a)(2), 1272(c), 1274(c), 1275(b).

⁷⁷ I.R.C. § 1272(a)(2)(A); see I.R.C. § 1275(a)(3) (definition of tax-exempt obligations).

⁷⁸ I.R.C. § 1272(a)(2)(B).

⁷⁹ I.R.C. § 1272(a)(2)(C).

⁸⁰ I.R.C. § 1272(a)(2)(D).

use property. Personal use property includes property not used substantially in the taxpayer's trade or business.⁹⁰

Reporting Requirements and Penalties

The information requirements which must be satisfied in the case of any debt instrument having OID are set forth in Section 1275(c). The Secretary is authorized to issue regulations requiring that the amount of OID and the issue date be stated on the debt instrument. However, in the case of any obligation *not publicly offered*, the regulations may not require the information to be set forth prior to the disposition of the debt instrument *by the first buyer*. Failure to furnish the information required will result in a penalty of \$50 for each instrument not so furnished unless the failure is due to reasonable cause and not willful neglect.⁹¹

In the case of publicly offered debt instruments having OID, the issuer must furnish to the Secretary the amount of the OID, the issue date, and any other information required by the regulations to be furnished. The penalty for failure to provide the information required is the payment of one percent of the aggregate issue price of the issue, unless the failure is due to reasonable cause and not willful neglect. The penalty with respect to any issue of debt instruments is not to exceed \$50,000.⁹² Finally, Section 1275(c)(3) specifically excepts from the reporting requirements debt obligations exempted from the current inclusion of OID under Section 1272(a)(2).⁹³

Section 483: Imputed Interest

With the expansion of the OID rules to debt instruments given in consideration for the sale of property, TRA '84 greatly reduces the scope of Section 483. Generally, the unstated or imputed interest rules apply only to the sale of property under a contract that falls within an exception to the OID provisions and does not meet a certain minimum rate of interest.⁹⁴ Thus, Section 483 has become the backstop for the OID provisions.

⁹⁰ I.R.C. § 1275(b)(3). The purchaser of a home in which the purchaser expects to maintain an office may not be subject to the § 483 rules or the OID rules. Senate Report, note 1 *supra*, at 258.

⁹¹ I.R.C. § 6706(a).

⁹² I.R.C. § 6706(b).

⁹³ See text accompanying notes 76-85 *supra*.

⁹⁴ TRA '84 § 61(c).

Under new Section 483, the debt instrument must provide for an interest rate of at least 110 percent of the applicable federal rate, compounded semiannually.⁹⁵ If the safe-harbor test is not met, an interest rate of 120 percent of the applicable federal rate, compounded semiannually, is imputed for purposes of computing unstated interest.⁹⁶ The amount of unstated interest allocable to each payment is determined in the same manner as the daily portions of OID are determined under Section 1272(a).⁹⁷ Thus, in addition to increasing and compounding the interest rates involved, the amendments to Section 483 result in the allocation of unstated interest to each payment on an economic accrual basis.

Generally, the exceptions to Section 483 include debt instruments to which Section 1272 applies, property with a sales price of \$3,000 or less, carrying charges under Section 163(b), and certain sales of patents.⁹⁸ Section 1275(b) excepts borrowers from the provisions of Sections 1274 and 483 if the debt instrument is given in consideration for the acquisition of personal use property. With respect to the sale of land used as a farm or the sale of a principal residence by an individual (to the extent the purchase price of the residence does not exceed \$250,000), the pre-TRA '84 testing and imputed interest rates of 9 percent simple interest and 10 percent compounded semiannually, respectively, are substituted for the current rates.⁹⁹ Finally, the maximum interest rate applicable to real estate transactions between related parties involving \$500,000 or less is 7 percent, compounded semiannually.¹⁰⁰

Conclusion

The Tax Reform Act of 1984 substantially expanded the scope of the OID provisions. In accordance with the legislative intent, the statute mandates an accrual of interest on debt obligations that approaches economic reality. In addition, the Treasury has won its battle to match interest expense deductions with the inclusion of interest income in a

⁹⁵ I.R.C. §§ 483(b), 483(c)(1). Section 483 applies to a debt instrument that constitutes part or all of the sale price and which is due more than six months after the date of sale or exchange under a contract providing for some or all payments to be due more than one year after the date of sale or exchange. *Id.*

⁹⁶ I.R.C. § 483(b).

⁹⁷ I.R.C. § 483(a).

⁹⁸ I.R.C. § 483(d).

⁹⁹ I.R.C. § 483(e).

¹⁰⁰ I.R.C. § 483(f).

significant percentage of the transactions involving low interest and accrued interest loans. Unfortunately, taxpayers now are forced to deal with a set of rules that few will fully understand. A model of tax simplification these provisions are not.

There is a possibility that the OID provisions will be repealed in the next year or two. In an atmosphere of budget cuts and tax increases, however, the probability of outright repeal of a revenue-raising statute, even a complicated one, is not very high. More likely is an amendment to make the provisions applicable only to large transactions. What constitutes a large transaction will likely be the subject of extended debate. For the present, however, tax practitioners will have to keep a watchful eye on transactions involving debt instruments considered by their clients.

The Flat Rate Tax Proposals

"Many of the [flat rate] tax proposals suggest retaining only those deductions which are commonly available to most taxpayers. . . . To package a tax plan as being 'simple' when it 'retains deductions most commonly available' is inherently contradictory because the complexities which most commonly confuse taxpayers are retained."

—Glenn A. Henkel
Tax Notes
January 7, 1985