

TAX SECTION

# New York State Bar Association

Report of Ad Hoc Committee on Proposed  
Original Issue Discount Regulations

December 30, 1986

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Copies of the attached letter dated January 5, 1987 enclosing the Report on Proposed Original Issue Discount Regulations were sent to the following:

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January 5, 1987

The Honorable Lawrence B. Gibbs  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, NW  
Washington, DC 20224

Dear Commissioner Gibbs:

The Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984 significantly amended the federal income tax rules for original issue discount ("OID"). The method of computing OID was changed and the types of transaction to which the OID rules apply dramatically expanded. For example, the OID rules were extended to consumer loans and to seller financed sales of real estate and other property not publicly traded.

In April 1986, the IRS issued extensive proposed regulations interpreting and implementing the 1982 and 1984 amendments. The enclosed report of a special committee of the Tax Section chaired by James M. Peaslee and Willard B. Taylor comments on the Proposed Regulations\*.

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\* This report supplements a 1983 Tax Section report on OID and coupon stripping.

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The report's principal recommendations, summarized on pages 5 through 12, include comments on the following:

- (a) Intention-to-call rule;
- (b) Definition of a "de minimis" mount of OID;
- (c) Definition of "qualified periodic interest Payments";
- (d) Holder puts and issuer calls;
- (e) Accrued interest;
- (f) Installment obligations;
- (g) Principal prepayments;
- (h) Information reporting and legending;
- (i) Contingent payment obligations;
- (j) Variable rate obligations;
- (k) Section 1274 rules for "potentially abusive situations" and modifications and assumptions;
- (l) Residential mortgages and other consumer loans (including "rule of 78s" loans and loans with an initial incentive rate of interest);
- (m) Convertible and exchangeable debt instruments; and
- (n) Debt instruments denominated in foreign currencies.

Many of the recommendations are technical in nature. However, to avoid inappropriate results we believe that significant changes are needed in the proposed rules for contingent payment obligations issued for cash or publicly traded property.

We would be pleased to work with Treasury and IRS on further development of regulations in this area.

Sincerely,

Richard G. Cohen  
Chairman

RGC:jl

Enclosure (2 copies)

cc: The Hon. J. Roger Mentz (w/enclosure)

REPORT #555

New York State Bar Association Tax Section  
Report of Ad Hoc Committee on Proposed  
Original Issue Discount Regulations

December 30, 1986

New York State Bar Association Tax Section  
Report of Ad Hoc Committee on Proposed  
Original Issue Discount Regulations<sup>1</sup>

I. INTRODUCTION

Proposed regulations under sections 163, 446, 483, 1271 through 1275 and other related sections of the Internal Revenue Code of 1986 (the "Code") were published in the Federal Register on April 8, 1986 (the "Proposed Regulations").<sup>2</sup> The Proposed Regulations implement changes to the original issue discount ("OID") rules of the Code enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and the Tax Reform Act of 1984 ("TRA 1984"). This report comments on the Proposed Regulations.

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<sup>1</sup> This report was prepared by a committee consisting of James M. Peaslee and Willard B. Taylor, Co-Chairmen, and Charles M. Adelman, Renato Beghe, Peter C. Canellos, William G. Cavanagh, Suzanne F. Greenberg, Karen L. Halby, James S. Halpern, Stephen B. Land, David Z. Nirenberg, Joseph R. Parise, Barnet Phillips, Michael L. Schler, Lewis R. Steinberg, Stewart Stern and Gordon E. Warnke. James M. Peaslee coordinated the preparation of the report. Helpful comments were received from William L. Burke, Richard G. Cohen, John A. Corry, Richard M. Fabbro, David Garlock, Richard L. Reinhold and Donald Shapiro.

<sup>2</sup> 51 F.R.12022, with corrections at 51 F.R. 23431 (June 27,1986). Except as otherwise indicated, all section references herein in the form "section 1.\_\_\_\_" are to sections of the Proposed Regulations, or of other regulations under the Code, and all other section references are to sections of the Code.

Following the enactment of TEFRA, the Tax Section submitted a report on issues relating to OID and coupon stripping to be addressed in regulations and corrective legislation (the "1983 Report").<sup>3</sup> A number of the recommendations made in the 1983 Report were incorporated in the TRA 1984 amendments and in the Proposed Regulations.

On the whole, we believe that the Proposed Regulations represent a thoughtful attempt to apply the complex OID rules of the Code. They provide much needed guidance with respect to many previously unresolved questions. The drafters are to be commended for their efforts. We do, however, have numerous comments.

To a large extent, the Proposed Regulations illustrate and clarify rules spelled out in some detail in the Code. However, under section 1275(d), the Treasury has authority to write regulations in effect to "fix" the OID rules in the Code if they do not work properly by reason of varying rates of interest, put or call options or contingent payments, among other circumstances. The Proposal Regulations include rules in each of these three specific areas. These rules work reasonably well in the case of variable rate obligations and obligations subject to put or call options. However, we believe that significant changes in the proposed rules governing

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<sup>3</sup> Reprinted in Tax Notes, March 5, 1984, at 993. All citations herein to pages of the 1983 Report will be to pages of the Tax Notes reprint.

contingent payment obligations will be necessary to avoid inappropriate results.

One important area that is not addressed to any extent in the Proposed Regulations concerns debt obligations that are prepaid. The significance of these types of obligations, in terms of the administration of the OID rules, has increased markedly in recent years with the extension of those rules, via TRA 1984, to obligations of individuals and the development of a public market for securities backed by residential mortgages.

In a number of circumstances, the Proposed Regulations provide rules distinguishing ordinary income (generally interest income) from capital gain. The importance of that distinction has been significantly reduced as a result of the Tax Reform Act of 1986 ("TRA 1986"). Nonetheless, given that capital losses will continue to be useable only to offset capital gain, that the Code provides special treatment of interest income in a number of areas, that the Proposed Regulations would by their terms generally be effective beginning in 1982, whereas the top marginal rates for ordinary income and long-term capital gain will be conformed only in 1988, and that the law may at some point be changed again to provide lower marginal rates for long-term capital gain, we have assumed that it will continue to be worthwhile to draw properly the line between interest income and capital gain.

The balance of this report consists of a summary of our principal comments and a more detailed discussion.

## II. SUMMARY

1. Intention to Call. Regulations interpreting the intention-to-call rule under section 1271(a)(2) (which are reserved in the Proposed Regulations) should follow the existing regulations under section 1232, with some technical modifications. It should be made clear that those rules do not apply to obligations that are subject to mandatory prepayment conditioned on events outside of the issuer's control.

2. De Minimis OID. The definition of OID should incorporate an expanded de minimis rule for discount that arises because stated interest fails to be qualified periodic interest. The rule would generally apply to a debt instrument if the cumulative amount of income that would be deferred or accelerated if the instrument were held by a cash basis taxpayer and the OID rules did not apply could never exceed an amount equal to six months worth of interest on the instrument.

3. Qualified Periodic Interest. The definition of qualified periodic interest should be amended to include interest paid at the end of an initial or final "long" accrual period, in an amount properly adjusted to reflect the length of the period. The application of the definition of qualified periodic interest to short-term obligations (which is significant in determining the scope of the withholding tax exemption under section 871(g) for OID on debt instruments having a term of 183 days or less) should be clarified.

4. Accrued Interest. The regulations should clarify the treatment of accrued interest that is paid upon purchase of a debt instrument. Accrued interest paid on the issue date should be included in the issue price. Additional accrued interest should be treated as a separate item that may be offset against the next interest payment.

5. Prepayments. The regulations should be amended in a number of respects to take account of prepayments of principal. The amount of OID or market discount that is considered to be paid in the event of a partial prepayment of a debt instrument should be limited to the portion of the discount that is properly allocable to the principal that is prepaid, calculated in such a manner that the yield of the instrument remains constant over its life.

6. Information Reporting and Legending. Consideration should be given to eliminating the requirement that OID information be set forth on the face of a debt instrument. Application of the legending requirement (to the extent it is preserved) and the section 1275(c) information reporting requirement to pass-through securities should be clarified.

7. Contingent Payments. The rules for contingent payment obligations should be modified in a number of respects. The new rules should be based primarily on a "comparable noncontingent bond approach". Under that approach, the tax treatment of an obligation that provides for some noncontingent payments and some

payments contingent in amount would be determined by reference to a "comparable noncontingent bond" that would provide for the same noncontingent payments and, in lieu of the contingent payments, payments in fixed amounts calculated so that the obligation would have an initial yield to maturity equal to an "assumed rate" (an objectively determined market interest rate). Interest would initially be reported by the issuer and holders as it accrues based on the assumed rate, subject to adjustment as contingent payments become fixed. Rules should be added for obligations issued for cash or publicly traded property that are fixed in amount but uncertain as to the time of payment. Obligations that are contingent solely because of the existence of an unconditional option of the holder or issuer to force the retirement of the obligations at a fixed price should not be subject to the contingent payment rules but should be governed exclusively by the put/call rule in section 1.1272-1(f)(4). The contingent payment rules should be applied to convertible and exchangeable debt instruments with some exceptions (see paragraph 12 below). The regulations should deal with the character of gain recognized by the seller of a contingent payment obligation and the reporting of income by a subsequent holder. The regulations should also clarify whether the imputed interest rules continue to apply (as they did before TRA 1984) to contingent stock issued as additional consideration in a reorganization where the stock of the acquired corporation is publicly traded.

8. Variable Rate Obligations. The rules for variable rate obligations should be expanded to apply to a broader class of instruments, in terms of permissible interest rate indices and the formulae used in computing rates. The regulations should also address the effect of interest rate caps and floors.

9. Section 1274. The Proposed Regulations under section 1274 relating to "potentially abusive situations" should be changed to acknowledge the possibility that amounts due on a debt instrument may be considered to be contingent if those amounts are not likely to be paid because of the excessive valuation of property. The rules for determining the applicable Federal rate for an installment obligation should be simplified. Under the Proposed Regulations, if a debt instrument is modified in connection with a sale of property and assumption of the debt instrument, that modification is treated as a separate transaction from the sale. We recommend abandonment of this "separate transaction" approach.

10. Section 446. The Proposed Regulations under section 446 should be amended to ensure that interest will be reported consistently by the borrower and lender except with respect to de minimis prepayments (for example, less than three months), to provide guidance as to the treatment of principal prepayments and to ensure that interest will be reported under an economic accrual method regardless of the terms of the loan.

11. Consumer Loans. TRA 1984 extended the OID rules to consumer loans. The effect of the Proposed Regulations on a number of common types of consumer loans needs to be clarified. The proposed treatment of loans providing for interest computed under the "rule of 78s" is irreconcilable with published rulings issued after the enactment of TRA 1984. The treatment of buydown funds and certain other amounts paid in connection with the origination of a loan should be clarified. Buydown funds that are truly an asset of the borrower should not be considered to be "paid" to the lender. The treatment of loans originally subject to section 483 that are purchased from the original holder for cash at a discount should be clarified. We recommend that such discount be governed exclusively by the market discount rules of sections 1276-1278.

12. Convertible and Exchangeable Instruments. We recommend that debt instruments that are convertible into, or exchangeable for, stock or other property at the holder's option be governed by the contingent payment rules (with the result that gain attributable to the option generally would be treated as interest at the time when the option is exercised), with an exception for debt instruments that are convertible into or exchangeable for stock of the issuer or an affiliate of the issuer where either no gain or loss would be recognized under current law upon exercise of the conversion right or the issuer would be denied a deduction for a premium paid in respect of the conversion or exchange option under section 249. The current law

treatment of debt instruments subject to the exception would be preserved.

13. Foreign Currency. TRA 1986 includes specific rules for the tax treatment of foreign currency transactions, effective for taxable years beginning after December 31, 1986. In view of this statutory change, we recommend that regulations on this subject not be issued covering prior periods (except to the extent necessary to address the treatment under the new rules of transactions that began before 1987 and continue after 1986).

### III. COMMENTS

#### 1. Intention to Call Rule.

##### A. Overview.

Under section 1271(a)(2), if at the time of issuance of a debt instrument the issuer thereof had "an intention to call [the] debt instrument before maturity", then gain realized on the sale or exchange of that debt instrument is treated as ordinary income in an amount not exceeding the portion of the OID thereon that has not yet accrued at the time of the sale or exchange. The purpose of this rule is to correct a distortion that would arise if the rate of accrual of OID on an obligation is computed based on its stated maturity date but the issuer has tacitly agreed to redeem it before that date. In the absence of the rule, gain attributable to the unaccrued OID remaining at the time of the redemption would generally be taxable to the holder as capital gain even

though such gain is in substance part of his guaranteed return.

The predecessor of section 1271(a)(2) was first enacted in 1958. The 1958 legislative history states that the intention-to-call rule is intended to be "confined to the areas of abuse".<sup>4</sup> In particular, because the issuer of an OID instrument would expect to suffer economically if it called the obligation before maturity, an intention to call would not ordinarily exist in the absence of an understanding or agreement between the issuer and the holders of the obligation that a call right will be exercised.<sup>5</sup> Therefore, the legislative history properly focuses on factors indicating the absence of collusion in determining whether an intention to call exists.

For example, according to the legislative history, if an obligation is part of an issue registered with the Securities and Exchange Commission ("SEC") and is sold to the public without representation that the

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<sup>4</sup> S. Rep. No. 1983, 85th Cong., 2d Sess. 75, 204, reprinted in 1958 U.S. Code Cong. & Ad. News 4791, 4864-4865, 49-4994 ("1958 Report").

<sup>5</sup> An issuer of a debt obligation having OID would not ordinarily have, at the time of issuance, an economic incentive to call the obligation before maturity because the yield of the obligation would be greater if it were called. In the unusual case where the interest rate on the debt obligation increased after a call date to such an extent that the yield of the instrument would be reduced if the obligation were called, the issuer would have an economic incentive to exercise the call right. There is no need to apply the intention call rule to such an obligation, however, because the call date of the obligation would be treated as its maturity date for purposes of determining the rate of accrual of OID under the put/call rule in section 1.1272-1(f)(4).

issuer has an intention to call the obligation before maturity, there is a presumption that there is no such intention. Other factors cited in the legislative history that may evidence the lack of an intention to call are that the issue price and term of the obligation appear to be reasonable, and the original purchaser and the issuer are not related and have not engaged in other transactions with each other.<sup>6</sup>

Section 1.1232-3(b)(4) closely follows the approach suggested by the legislative history. That approach is a sensible compromise between granting the Internal Revenue Service ("IRS") the authority to attack abuses and giving issuers of debt instruments who have not engaged in the types of transactions that Congress considered abusive assurance that their debt instruments will not be considered to have been issued with an intention to call merely because of the existence of a call right.

The Proposed Regulations reserve regulations on the intention-to-call rule. We believe that the. Current regulations properly implement the rule and should be incorporated in the final regulations under section 1271 with some minor revisions described below. The authors of the Proposed Regulations may have acted with restraint because of uncertainty as to whether the intention-to-call rule should be extended to obligations that must be prepaid if certain conditions outside of the control of the issuer are met (such as certain mortgage

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<sup>6</sup> 1958 Report, 4993-4994.

backed bonds that are required to be prepaid out of payments received on the mortgage collateral). While the prospect of mandatory prepayments does raise some issues in applying the OID rules (see the discussion of the contingent payment rules in part III.8.), in our view, extending the intention to-call rule would not be an appropriate response because the penalty imposed would be harsher than the crime. In particular, the amount of gain on sale of a debt obligation that, would be converted to ordinary income under a more properly tailored rule would be only the excess of (i) the OID that would have been reported by the seller while he held the obligation if OID had been accrued over the period from the issue date to the date on which the call right was intended to be exercised over (ii) the OID actually reported by the seller. However, under section 1271(a)(2), the amount of gain that may be converted to ordinary income is not this amount but rather the full amount of unaccrued OID remaining at the time of the sale.<sup>7</sup> Moreover, the amount of converted gain is not reduced by the excess (if any) of the purchase price paid by a holder of a debt obligation over the revised issue price of the obligation at the time of the purchase, unless that excess is so large that the holder buys the obligation at a premium. Therefore, the amount of gain recognized by a holder that is affected by the intention-to-call rule can exceed the

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<sup>7</sup> Thus, if shortly after the issuance of an OID bond, market interest-rates dropped sharply so that the bond rose in value to 100% of its principal amount, the bond was sold, and the section applied, the entire gain on the sale would be converted to ordinary income even though the gain is attributable almost exclusively to factors other than the under accrual of OID.

total amount of OID that would have accrued to the holder in the future on the obligation.<sup>8</sup> These anomalies in the statute can be justified, if at all, only if the rule is strictly confined to the abusive transactions that led to its enactment.

Apart from the fact that applying the intention-to-all rule produces inappropriate results, we question whether there would in fact be an "intention to call" within the meaning of section 1271 because the issuer may be required to call based on events outside of its control. At the least, it must be recognized that this is a different case from the tacit agreement binding the issuer to call that the drafters of the rule had in mind.

B. Modification of the Current Regulations.

As noted above, we believe that section 1.1271-2 should incorporate rules similar to those currently found in section 1.1232-3(b)(4). We would, however, recommend three technical changes:

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<sup>8</sup> For example, suppose that a bond having a stated redemption price at maturity of \$1,000 is sold by an original holder A to holder B for \$900 at a time when the revised issue price of the bond is \$800. If interest rates dropped, B immediately resold the bond for \$1,050, and the intention-to-call rule applied, the entire \$150 gain would be converted to ordinary income because it does not exceed the remaining amount of unaccrued OID (\$200) determined, as section 1271(a)(2)(A) requires, without an adjustment for the acquisition premium paid by B. Thus, the amount of B's gain that is converted to ordinary income (\$150) exceeds the aggregate amount of OID that would have been reported by B if he had held the bond to maturity (\$100).

First, in the case of publicly offered obligations, we see no reason for limiting the presumption of a lack of an intention to call that arises when no such intention is represented by the issuer to obligations registered with the SEC. The rationale for such a rule, presumably, is that in a public offering the offering document provides the sole means of communication between the issuer and potential purchasers. The same reasoning would apply to public offerings that are not SEC registered. The special rule for determining the issue price in public offerings, now found in section 1273(b)(1), was extended by TRA 1984 from SEC registered offerings to all offerings and a conforming change should be made in the regulations dealing with the intention-to-call rule.<sup>9</sup>

A second change that we recommend relates to the calculation of the amount of unaccrued OID that is taken account under the intention-to-call rule upon sale of a debt instrument. Because the purpose of the rule is to require holders to report as ordinary income the amount of ordinary income that would have been included in income, as accrued OID, over the period from the issue date to the call date, if the instrument had required exercise of the call, such unaccrued OID should not include amounts that would not be paid if the call right were exercised. For example, unaccrued OID should exclude any coupon interest that is treated as OID because it is

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<sup>9</sup> For these purposes, the term "publicly offered" should have the same meaning as it has in section 1.1273-2(a)(2). See part III.4.D.

not qualified periodic interest but that would be forfeited if the instrument was called.<sup>10</sup> We believe that the Treasury has authority to adopt this position in regulations under the grant of authority in section 1275(d) because the problem arises from the unconventional terms of a debt instrument that results in coupon interest being included in the stated redemption price at maturity.

Third, section 1.1271-2 should state that the existence of an obligation to call a debt instrument before maturity conditioned on events outside of the control of the issuer will not cause the issuer to be considered to have an intention to call the obligation even if those events are likely to occur.<sup>11</sup> Similarly, the regulations should clarify that the existence of a mandatory sinking fund does not by itself cause the intention-to-call rule to apply. For further comments on mandatory sinking funds, see part III.16.A. below.

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<sup>10</sup> To illustrate, suppose that a newly issued debt instrument provides for a single payment of principal of \$1,000 at the end of ten years and interest payable annually of \$80, beginning at the end of two years. Because no interest is payable in the first year, all of the interest payments are included in the stated redemption price at maturity. If the instrument is callable at a price of \$1,000 immediately after any interest payment date, and the intention to call rule applies, the amount of gain that may be treated as ordinary income should be limited to the excess of \$1,000 over the revised issue price and not include any amount in respect of the interest that will not be paid if the call right is exercised.

<sup>11</sup> At the very least, it should be confirmed that the intention-to-call rule does not apply to a debt instrument if OID on that instrument is accrued based on an assumed prepayment rate under section 1272(a)(6), as amended by section 672 of TRA 1986.

## 2. Retirement/Short-Term Obligations.

Section 1271(b)(1) states that section 1271 shall not apply to any obligation issued by a natural person. Similarly, section 1.1271-1(a) states that “[s]ection 1271 and this section provide for the treatment of amounts received on retirement or sale or exchange of a debt instrument . . . other than a debt instrument issued by a natural person . . . .” These statements notwithstanding, section 1.1271-3(c), Example (2), involves a short-term obligation issued by an individual. While the result reached in Example (2) is likely to be the correct result under current case law, it would not seem to be a result reachable under section 1271. We recommend that the example be changed to omit the reference to an individual (or that a technical correction be made to extend section 1271(a)(4) to obligations of individuals).

Section 1.1271-3(a)(3) defines the “ratable share of acquisition discount” as an amount that bears the same ratio to the total acquisition discount as the number of days that the taxpayer holds the obligation bears to the number of days after the date the taxpayer acquired the obligation up to and including the maturity date. Section 1.1271-3(c), Example (1), calculates the ratable share of acquisition discount based on a 360-day year and 30-day months. If it is intended, as this example suggests, that the counting conventions that apply to “accrual periods” under section 1.1275-2(e) also apply in determining the ratable share of acquisition discount, this should be stated explicitly.

We note as a point of interest that section 1.1271-3(b), although issued last April, assumes enactment of the technical corrections provisions in TRA 1986 (see section 1803(a)(1)-(4) of TRA 1986). With some justification in this context, the Treasury has succumbed to the temptation of counting chickens before they are hatched.<sup>12</sup>

### 3. Mechanics of OID Calculation.

We have a number of comments relating to the method of calculation of OID accruals under section 1.1272.

#### A. Accrual Periods.

Section 1.1272-1(c)(2)(ii) provides a special rule for calculating the amount of OID allocable to short first accrual period. In general, such amount may be calculated under an exact method, an approximate method or any other reasonable method. The choice of method is to be reported to the IRS on Form 8281, where that form is otherwise required to be filed, and is included in the OID information that must be set forth on the face of a debt instrument if the leg ending rule applies. See section 1.1275-3. It is not clear whether there is any requirement of consistency in the choice of method, as between the issuer and holders of a single obligation, different obligations of the same issuer or different

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<sup>12</sup> See also section 1.483-1(c)(2)(i) which reflects the amendment to section 483(d)(1) by section 1803(a)(14) of TRA 1986.

obligations held by one taxpayer. Inasmuch as the variation in the timing of taxable income that is likely to result from the choice of one method over another should be insignificant for most taxpayers, we see no reason to insist on any form of consistency, except that, as section 1.1272-1(f)(2) requires, a taxpayer must calculate yield in a manner that conforms to the method chosen by the taxpayer to allocate OID to a short period.

Section 1.1272-1(c)(2)(iii) provides that the OID allocable to the final accrual period shall equal the excess of the stated redemption price at maturity over the adjusted issue price at the beginning of that period. The last sentence of the paragraph states that the rule does not apply to installment obligations. The reason for the general rule is, presumably, to ensure that the full amount of OID is reported over the life of an obligation notwithstanding rounding errors and other minor inaccuracies in the calculation of OID accruals. See 1983 Report at 1019. If this is the reason, it is not clear why the rule does not apply to installment obligations. We assume that the "final accrual period" to which the special rule refers means the final period before the maturity date of an obligation and not the last period before the obligation is actually retired. Thus, the special rule would not affect the amount of OID that accrues in an accrual period during which an obligation is prepaid.

The special rule for final accrual periods applies to short accrual periods as well as to whole

periods. The rule is adequate for purposes of calculating the amount of OID allocable to a short final period once the yield to maturity is known, but some other assumption must be made in order to calculate that yield. We recommend that a rule be added to the definition of yield to maturity in section 1.1272-1(f) to the effect that, in determining the yield to maturity of an obligation having a short final accrual period, the OID allocable to the final accrual period may be calculated in accordance with the rule for short first accrual periods in section 1.1272-1(c)(2)(ii), except that the adjusted issue price at the beginning of the final accrual period shall be substituted for the issue price.

The statement of the rule for short accrual periods in section 1.1272-1 (d)(iv) is somewhat difficult to follow. Subclause (B) should be amended to make it clear that in using the word "remainder," the reference is not to a remaining period of time following a short period of a length less than one full accrual period. Thus, the language of subclause (B) following the first comma could be rewritten as follows:

the final accrual period shall be the short period remaining after the expiration of that portion, if any, of such interval consisting of a whole number of accrual periods.

Before 1984, the term "bond period" (the predecessor of "accrual period") was defined in section 1232A(a)(5) for a bond, except as otherwise provided in regulations, as a one-year period (or the shorter period to maturity) beginning on the day in the calendar year which corresponds to the date of original issue of the

bond. TRA 1984 replaced this definition with the definition of accrual period in section 1272(a)(5), effective for obligations issued on or after January 1, 1985. Section 44(i)(1) of TRA 1984 provides that for obligations issued before January 1, 1985 and after July 1, 1982, the accrual period shall be a one-year period (or shorter period to maturity) beginning on the day in the calendar year which corresponds to the date of original issue of the obligation. Section 1.1272-1(d)(2) adopts this definition of accrual period for obligations issued in that period. We recommend that holders and issuers of obligations issued before 1985 and after July 1, 1982 also be given the option to use the same definition of accrual period as applies to post-1985 obligations. We suspect that many holders and issuers have, in effect, anticipated the 1984 changes and the Proposed Regulations in calculating OID accruals with respect to pre-1985 obligations. Inasmuch as the pre-1984 statute was, in our view, defective, or at least out of step with commercial practice (see the 1983 Report at 1019), we recommend that these past practices be legitimized-in the final regulations.

B. Adjusted Issue Price.

The special rule for determining the adjusted issue price of installment obligations found in section 1.1272-1(e)(2)(ii) is discussed in part III.6. below.

C. Put/Call Rule.

Section 1.1272-1(f)(4) provides a special rule for determining an obligation's yield to maturity if it is subject to a call by the issuer (or a put by the holder). Under that rule, it is presumed, at the time of issuance, that the call (or put) will be exercised only if such exercise would reduce (or in the case of a put, increase) such yield.

If under this rule it is initially presumed that a call right will not to be exercised, but the right is in fact ultimately exercised, then the debt is "considered redeemed prior to maturity". Section 1.1272-1(f)(4)(iv). Section 1.1272-1(k), Example (11), paragraph (iv), illustrates this situation, and states that on the exercise of the call, the holder will have capital gain under section 1001 equal to the excess of the call price over the revised issue price (and the issuer will obtain a corresponding interest deduction).

We support the general rule (which follows a recommendation in the 1983 Report at 1006, and with respect to the treatment of call premium, GCM 39543 (August 8, 1986)) and its application in the example. We believe, however, that the regulation should state that calls and puts of the type that are properly governed by section 1.1272-1(f)(4) (as discussed further below) will not be considered to create contingent payments that fall within section 1.1275-4. This would clarify that (i) fixed interest payments on an obligation do not become contingent solely because they will not be made if the issuer prepays the obligation before the interest

accrues, and (ii) the payment of a call price above the revised issue price generally results in capital gain rather than contingent interest income to the holder.<sup>13</sup> While the example described above assumes these results, we believe a more direct statement of the rule is appropriate.<sup>14</sup>

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<sup>13</sup> However, in the unusual case where the call right is irrevocably exercised a substantial period before the call date, as might be the case where a debt instrument is defeased, it might be appropriate to treat the change in terms represented by the agreement to exercise the call (if it was not previously presumed under section 1.1272-1(f)(4) that the call would be exercised on the date on which it will in fact be called) in the same manner as if a contingent payment governed by section 1.1275-4 had become fixed.

<sup>14</sup> The conclusion in clause (b) should also be included in the section 1271 regulations, since it frequently will arise with respect to debt obligations not issued with OID.

The put/call rule requires the calculation, as of the issue date of an obligation, of the yield of the obligation, assuming that the put or call is exercised. This can be done only if the price at which the put or call is exercisable is fixed from the beginning (or is fixed subject only to remote and incidental contingencies). The assumption of a fixed price should be made explicit. Similarly, if a put or call option is exercisable at a fixed price, but the right to exercise the option is subject to a contingency that is not remote and incidental, then the option should not be governed by section 1.1272-1(f)(4). Put or call options that are not subject to section 1.1272-1(f)(4) would be treated as contingencies that fall within section 1.1275-4. For further discussion of the relationship between the put/call rule and the contingent payment rules, see part III.8.C. below.

In determining the yield that would result if the put or call were exercised, sections 1.1272-1(f)(4)(iii)(A)(1) and (B)(1) state that the price at which the debt instrument could be purchased, sold or retired through exercise of the option should be treated as the stated redemption price at maturity. This treatment would be correct only if the obligation provided for a single principal payment that is fully satisfied through exercise of the option. We recommend that the rule be rewritten to accommodate installment obligations and options to purchase, sell or retire only a portion of an obligation. We also believe that the rule

should state that if a put or call can be exercised on more than one date (whether at the same price or different prices on each date), the date of exercise will be deemed to be the date that maximizes the yield (in the case of the put) or minimizes the yield (in the case of the call). It should also be made clear that if an option is presumed to be exercised at a price greater than the stated redemption price at maturity (determined disregarding the option), and the option is in fact not exercised, then the resulting premium will be includable in income by the issuer, and subject to amortization by holders under section 171, in the same manner as if a new obligation had been issued on the exercise date for cash equal to the exercise price.

As now written, the effect of the put/call rule is to "presume" that a put or call option will or will not be exercised. It appears that this presumption cannot be rebutted in advance of the option exercise date, and that the term presumption is intended only to mean that the assumed exercise of, or failure to exercise, the option may in fact not happen. This intent would be more clearly expressed if options were simply "treated" as being exercised or not exercised for purposes of the OID rules, subject to adjustment under section 1.1272-1(f)(4)(iv).

The put/call rule in the context of sections 1274 and 1.1274-6(f) is discussed in part III.10.G. below.

#### 4. Definition of OID.

A. The De Minimis Rule.

Section 1273(a)(3) provides that, notwithstanding the general definition of OID, OID on a debt instrument will be considered to be zero if it is less than a "de minimis" amount. Relaxing the application of the general OID rules to debt instruments issued with insignificant amounts of OID makes sense. While some slight benefit may be derived from requiring that the discount be treated in accordance with those rules, that benefit clearly is outweighed by the increased burden such requirement would place on the holders and issuers of such debt instruments as well as on the IRS.<sup>15</sup> Thus, we concur in Congress' belief that there is a need for some de minimis rule. However, we believe that the current rule does not cover all instances of truly insignificant amounts of OID.

Under section 1273(a)(3), the amount of discount that is considered de minimis is defined as a discount of less than .25% (25 basis points) of the stated redemption price at maturity of a debt instrument for each full year of the period from its issue date to maturity date. This rule works reasonably well in its application to a debt instrument that is in fact issued at a discount; that is, at an issue price less than its principal amount where

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<sup>15</sup> This burden includes compliance with the leg ending and information reporting requirements described in part III.7. and the listing of a debt instrument by the IRS in Publication 1212.

the principal amount equals the stated redemption price at maturity.<sup>16</sup>

However, in addition to such instruments, a debt instrument that is not issued at a discount below its principal amounts may nevertheless be treated as having OID due to the deferral of one or more interest payments. In such cases, the "deemed" discount, when tested under a de minimis rule that focuses on the dollar amount of OID, often will exceed the de minimis amount, despite the fact that the deferral of interest income that would result if the OID rules did not apply is truly insignificant. In our view, a different measure of a de minimis amount of discount is needed for such cases. To illustrate the problem with the existing rule, consider the following

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<sup>16</sup> Even as applied to such debt instruments, the current de minimis rule could still be criticized on two grounds. First, while the TEFRA amendments generally require that interest be compounded, the de minimis amount of discount continues to be calculated under a linear formula. As a result, issuance of a debt instrument at the maximum amount of discount that is de minimis rather than at par will generally increase the yield to maturity of the debt instrument by more than 25 basis points and the increase will be greater the longer the maturity of the debt instrument. For example, in the case of a bond bearing interest of 8% payable semiannually, the de minimis amounts of discount would be 1.25% and 2.5% of the principal amount assuming, alternatively, 5-year and 10-year maturities, which would increase the yield of the bond by 31.06 and 37.40 basis points, respectively. Nonetheless, we have no strong objection to the use of a linear formula, in view of its greater ease of application and the arbitrariness of the 25 basis point figure. A second criticism is that the de minimis rule is based on the number of full years, with no credit being given to partial years. While we would prefer a rule that gave credit to partial years, our primary concern is that mistakes will be made, for example, in a situation where a "10-year" bond in fact matures 9 years, 11 months and 25 days after its actual issue date. We recommend that the regulations include an example illustrating that the actual period between the issue date and maturity date controls, even in the case of an obligation that is dated prior to its issue date.

example. On November 28, 1986, Company X issues at par for cash a \$1,000 bond maturing on December 1, 1996 with principal payable only at maturity. The bond provides for interest at 9% per annum, payable monthly, beginning on January 1, 1987. No interest payment is made, and no interest accrues under the terms of the instrument, for November 29 and November 30, 1986. Thus, on January 1, 1987, as on each other interest payment date, Company X will make an interest payment of \$7.50. However, because no interest is paid or accrued for the first two days, it is likely that no portion of the 120 interest payments of \$7.50 will constitute qualified periodic interest and therefore all such payments will be added to the stated redemption price at maturity of the bond.<sup>17</sup> Thus, the

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<sup>17</sup> Where a debt instrument provides for interest at a rate that varies over the life of the instrument, only interest calculated at the lowest rate for any period is qualified periodic interest. The bond described above would likely be viewed as providing for no interest during an initial period (i.e., November 29 and November 30, 1986) and for interest at 9% thereafter. As a result, no interest would be qualified periodic interest and all amounts denominated as interest would be added to the stated redemption price at maturity. This analysis is consistent with the treatment of long first accrual periods provided for by the Proposed Regulations, which, as discussed in part III.4.B. below, generally is to divide such periods into a short first accrual period and a full second accrual period.

Alternatively, the bond could be viewed as providing for interest at a rate of 8.44% (30/32 times 9%, assuming a 30-day month) during an initial 32 day period (i.e., November 29 through December 31, 1986) and at 9% thereafter. In that event, on each interest payment date, interest up to 8.44% (\$7.03 for each payment date subsequent to January 1, 1987)

(footnote continued)

(footnote continued from previous page)

would constitute qualified periodic interest and only the excess (\$.47) would be added to the stated redemption price at maturity. However, even under this approach, the excess interest would result in OID of \$56.40, which would exceed the de minimis amount.

bond's stated redemption price at maturity will be \$1,900, its issue price will be \$1,000 and the OID on the bond will be \$900. Because this amount of discount exceeds the de minimis amount permitted under current law, the bond will be viewed as issued with OID despite the fact that its issue price and principal amount are equal, and the deferral of income resulting from a failure to pay interest at the same rate over the life of the bond is insignificant. This, to US, seems unreasonable.

The result obtained above is anomalous when analyzed in light of the purpose of the OID rules, and when Company X's bond is compared with other bonds that are not considered to be issued with OID. As the legislative history to the predecessor of the current OID rules suggests, the primary purpose of these rules is to prevent the mismatching of the income reported by cash basis holders of obligations issued at a discount with the deductions claimed by accrual basis issuers.<sup>18</sup> Thus, to prevent such mismatching, the OID rules generally require that OID be recognized by holders as it accrues. However, despite this purpose, both the Code and the Proposed Regulations generally provide that no OID is created on debt instruments issued at par that pay interest at least annually (see the definition of stated redemption price at maturity in section 1273(a)(2)).<sup>19</sup>

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<sup>18</sup> See H. Rep. No. 91-413, 91st Cong., 1st Sess. 109 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 146-147 (1969).

<sup>19</sup> Even if a debt instrument has OID because it is issued at a price less than its principal amount, stated interest that is payable at least annually and is thus qualified periodic

Thus, a cash basis taxpayer who holds such an instrument may defer the recognition of interest income on that instrument for up to one full year over its entire term even if the issuer is deducting such interest as it accrues.<sup>20</sup> Implicit in this, we believe, is a determination by Congress that deferral by a cash basis taxpayer of up to one full year of interest on a debt instrument is de minimis. Accordingly, we believe that Company X's bond described above, on which the maximum amount of income that can be deferred by a cash basis taxpayer is interest for one month, should not be considered to have any OID.

To accomplish this result, we recommend that the de minimis rule be expanded to include a new definition of a de minimis amount of discount for OID that results from the failure of stated interest to be qualified periodic interest. Because Congress has implicitly concluded that the deferral of interest income for a maximum of one year by cash basis taxpayers is de minimis, it would be appropriate to measure the deferral permitted under the new rule against that standard. However, because debt instruments may be expected to be issued throughout any given year, the maximum deferral of one year would likely result in an average deferral of only six months. Therefore, we propose that the new rule provide that OID attributable to the inclusion of

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interest is not required to be included in income by cash basis holders as it accrues.

<sup>20</sup> This would occur in the case of a holder who reports income based on the calendar year if interest is paid on January 1.

interest payments in the stated redemption price at maturity will be disregarded if, at no time during the life of the instrument, the absolute value of the difference between the (i) aggregate amount of interest and OID that would have been reported through that time if the OID rules had applied and (ii) the aggregate amount of interest income that would have been reported through that time by a cash basis taxpayer if the OID rules did not apply, exceeds  $\frac{1}{2}$  of the annual interest coupon (or possibly  $\frac{1}{2}$  of the yield to maturity of the instrument)<sup>21</sup> applied to the principal balance of the instrument at that time.<sup>22</sup> These calculations would be made assuming that the issue price of the instrument equals its principal amount.<sup>23</sup> Such a rule, we believe,

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<sup>21</sup> Because most debt instruments issued in the United States provide for semiannual interest payments, it could be argued that the maximum deferral period should be limited to three months rather than six. While we believe that a six-month period would be justifiable on the grounds set forth in the text, a three-month rule would address many of the problem cases that are encountered in practice. Another alternative might be to adopt a de minimis rule for stated interest that is included in OID because no interest is paid during a short initial period not exceeding 50% of a full accrual period. In any event, we recommend that the new de minimis rule be formulated with a view to exempting from the OID rules many of the most common forms of consumer loans (including home mortgages that provide for incentive rates of interest during the first year) Consumer loans are discussed in part III.13. below.

<sup>22</sup> In a case where the stated rate of interest declines over the life of an instrument, including interest payments in the stated redemption price at maturity and applying the OID rules would have the effect of deferring the interest income reported by holders. By stating the rule in terms of the absolute value of the difference between (i) and (ii) rather than the excess of (i) over (ii), the rule would also cover the case where applying the OID rules would produce only a de minimis benefit for holders.

<sup>23</sup> We recognize that some debt instruments are both actually issued at a discount and viewed as issued at a discount

would serve to remedy the abuse at which the OID rules are aimed without creating undue complexity and hardship where no real abuse exists.<sup>24</sup>

The need for a broader de minimis rule stems from the unusual payment terms of certain debt instruments, combined with the stringent definition of stated redemption price at maturity in the Proposed Regulations. In our view, the rule could be adopted in regulations under the authority of the language in section 1275(d) concerning "varying rates of interest" and "other circumstances".

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because of the inclusion of interest payments in the stated redemption price at maturity. In such cases, we believe it is appropriate to measure each discount against its own de minimis rule to determine whether or not such discount is too significant to be ignored. This would conform the rule to the treatment of bonds that pay interest annually. Even though those bonds provide for some element of deferral of income as compared with bonds that provide for interest payments at more frequent intervals, the rule that applies in determining whether any discount attributable to the difference between the issue price and the principal amount is de minimis is the same for all such bonds.

<sup>24</sup> One type of obligation that may benefit from the new de minimis rule is collateralized mortgage obligations secured by pass-through securities representing interests in a pool of residential mortgages ("CMOs"). CMOs typically provide for quarterly interest payments. However, interest may be paid on the first interest payment date in respect of a period that is shorter, by as much as a month, than the actual period from the issue dates to the first payment date. For example, the first payment date may occur four months after the issue date even though three months worth of interest is paid on each payment date including the first payment date. The reason for this feature is to better match payments on the CMOs with payments on the underlying pass-through securities which typically provide for a delay in the distribution of payments of one month or more after those payments are due from the Mortgagors

Section 1.1273-1(a)(3)(ii)(A) provides that in applying the de minimis rule to installment obligations, the "weighted average maturity" will be substituted for the number of full years from the issue date to the maturity date. The weighted average maturity is defined as the sum, for all payments included in the stated redemption price at maturity, of the number of full years until a payment is made, multiplied by a fraction, the numerator of which is the amount of the payment and the denominator of which is the stated redemption price at maturity. While it is common in commercial practice to calculate the weighted average maturity of an installment obligation, this is ordinarily done by taking into account fractional portions of a year. In order to conform the rule to commercial practice and still give effect to the principle that the de minimis amount is calculated with respect to the number of full years from the issue date to the maturity date, we recommend that taxpayers be permitted to use in the de minimis calculation the weighted average maturity, calculated taking account of fractions of years, rounded down to the next whole number of years.

B. Stated Redemption Price at Maturity.

Under section 1.1273-1(b)(1)(i), all amounts payable on a debt instrument are included in the stated redemption price at maturity other than qualified periodic interest payments.<sup>25</sup> A qualified periodic

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<sup>25</sup> While the Proposed Regulations use the term "qualified periodic interest payments," the abbreviated phrase "qualified periodic interest" is sometimes used in this report.

interest payment is defined in section 1.1273-1(b)(1)(ii) as any one of a series of payments equal to the product of the outstanding principal balance of the debt instrument and a single fixed rate of interest, or a variable rate governed by section 1.1275-5, that is actually and unconditionally payable "at fixed, periodic intervals of one year or less during the entire term of [the] debt instrument (including short periods)." A special rule for short periods states that a portion of any payment due at the end of a short period shall be a qualified periodic interest payment only to the extent interest is properly allocable to such period using the same rate of interest applicable to full periods under the debt instrument.<sup>26</sup> The special rule also states that "[a] payment at the end of a short final accrual period shall not fail to constitute qualified periodic interest merely because the interval between such payment and the preceding payment differs from the fixed, periodic

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<sup>26</sup> The special rule adds that if the debt instrument has OID, the portion of the payment due at the end of a short period that is qualified periodic interest shall be calculated in a manner consistent with the determination of yield for the short period under section 1.1272-1(f). The regulation referred to says only that yield on a debt instrument shall be determined in a manner consistent with the method chosen for allocating the amount of OID with respect to the short period, under section 1.1272-1(c)(2)(ii). It would be more helpful if, instead of referring to section 1.1272-1(f), the special rule for short periods in section 1.1273-1(b)(ii) stated that the interest allocable to a short period will be determined under the principles of section 1.1272-1(c)(2)(ii) as if the stated interest rate were the yield to maturity, regardless of whether the debt instrument has OID.

interval between other payments under the debt instrument.<sup>27</sup>

Intervals between payment dates could be considered to be "fixed", in the sense of being invariable, even if the intervals were not the same. For example, if a bond provided for quarterly interest payments for the first two years and semiannual payments thereafter, interest could be said to be payable on the bond at "fixed" intervals, first of three months and then of six. Nonetheless, the Proposed Regulations strongly imply that "fixed, periodic intervals" means "intervals of equal length" with the sole exception of an initial or final short period. We see no reason, in terms of the policy of the OID rules, why the definition of qualified periodic interest should be so limited. As long as an interest payment period is not longer than one year and the interest that is paid at the end of the period properly reflects the length of the period, why should it matter that the period differs from other intervals between payment dates on the instrument?

The only reason we can see for a narrower construction is the desire to avoid the complexity associated with rules that accommodate different intervals between payment dates. For example, if interest payments on a bond were made quarterly for two years and thereafter every six months and interest payments at the end of both the three month and six-month periods were to

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<sup>27</sup> Curiously, there is no comparable statement regarding payments at the end of short initial accrual periods.

be treated as qualified periodic interest, then the accrual periods would have to correspond to the payment intervals, and not be three months over the entire term of the bond, which would be the result under section 1.1272-1(d)(1)(ii).

While we do not believe that it would be overly difficult to draft such rules, we suspect that most of the demand for them would be satisfied if the regulations permitted initial and final "long periods" on the same terms as initial and final short periods. Where a debt instrument is issued shortly before the next date corresponding to a regular interest payment date, it is not uncommon to skip the interest payment on that next date and provide that interest will first be paid on the second regular interest payment date for the full period from the issue date to that second regular interest payment date.<sup>28</sup> In the absence of a special rule for long initial periods, it appears that none of the stated interest on the instrument would be qualified periodic interest, even if the initial period extends beyond the regular interval between payment dates by only a single day.<sup>29</sup> In the event that the definition of qualified

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<sup>28</sup> For example, if a loan providing for regular quarterly interest payments on the first day of January, April, July and October is issued on December 15, 1986, the first interest payment might be due April 1, 1987 for the period from December 15, 1986 through March 31, 1987.

<sup>29</sup> Under section 1.1272-1(d)(1)(ii), the initial long period would be divided into two accrual periods, consisting of a full accrual period corresponding to the interval between payment dates and ending on the first payment date and a short accrual period from the issue date to the beginning of the first full accrual period. While the relationship between  
(footnote continued)

periodic interest is not revised generally to accommodate payments of interest at invariable but different periods of one year or less over the life of an obligation, then we recommend that a special rule be adopted for long initial or final periods.<sup>30</sup>

Section 1.1273-1(b)(1)(ii)(D) states that, in the case of a short-term obligation as defined in section 1283(a)(1)(A) (an obligation having a fixed maturity date not more than one year from the date of issue), no payments of interest shall be considered to be qualified periodic interest. One important consequence of this rule

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accrual periods and the "fixed, periodic intervals" referred to in the definition of qualified periodic interest is not entirely clear, it is possible that interest would be considered to be paid at a zero percent rate in respect of the initial short accrual period because no interest is actually paid at the end of that period, rather than at the regular rate for the entire initial period with interest being paid at the end of that period, with the result that no interest on the instrument would be qualified periodic interest.

<sup>30</sup> Long final periods are less common than long initial periods, but they are sometimes found in practice. A second situation where interest payment periods of differing length are likely to be encountered is where a fixed rate obligation converts to a variable rate obligation (which might provide for interest payments at more frequent intervals). A special rule for such instruments is found in section 1.1273-1(b)(1)(ii)(B), but it is not clear if that rule accommodates a switch in payment periods, as well as in the method of setting interest rates. While adoption of the modified de minimis rule proposed in part III.4.A. above would in many cases eliminate OID with respect to a debt instrument that has OID only because of a long initial or final period, the recommended change in the de minimis rule would be needed even if special rules for applying the definition of qualified periodic interest to long periods are adopted, to deal with the case where interest is not paid at a constant rate (e.g., where three months of interest is paid at the end of an initial long period of four months on a bond that generally provides for quarterly interest payments).

is that it exempts all interest on debt obligations having a term of 183 days or less from withholding tax in the hands of non U.S. investors. Section 871(g) provides, in effect, that the 30% withholding tax generally imposed by sections 871(a) and 881(a) on payments of interest (including OID) to such investors will not apply to OID in the case of debt obligations payable 183 days or less from the date of original issue. Regulations under section 1232 made it clear that this exemption applied to an obligation that was not sold at a discount below its principal amount but provided for a single interest payment at maturity (section 1.1232-3(b)(1)(iii)(e)). This result was not surprising because there is no economic difference between a non-interest bearing obligation sold at a discount and an obligation sold at par that provides for a single interest payment at maturity. Section 1.1273-1(b)(1)(ii)(D) would have the effect of extending the exemption to obligations that provide for stated interest payments prior to maturity. If this result is intended, a cross-reference to sections 871 and 881 would be desirable. If it is not intended, any narrowing of the rule beyond what is now stated in section 1.1273-1(b)(1)(ii)(D) should not be retroactive. In any event, the rule in the section 1232 regulations for interest payments only at maturity should be preserved.

Section 1.1273-1(b)(3) refers to a debt instrument containing a put or call option that is not "separately tradable" and that is presumed to be exercised under the put/call rule. That rule uses the

term "separately alienable" rather than "separately tradable". The language in the two sections should be conformed.

C. Accrued Interest.

The Proposed Regulations should deal more explicitly with the treatment of accrued interest that is paid upon the purchase of a bond.

Where the period from the issue date of a bond to its first payment date is shorter than the interval between interest payment dates, it is common to provide for a full interest payment on the first payment date and to charge purchasers of the bond a stated price plus accrued interest from a date that precedes the first payment date by a period corresponding to the interval between payment dates. For example, if a bond providing for interest payments on January 1 and July 1 is issued on January 15, 1987, typically a full six months of interest would be paid on July 1, 1987 and the issue price would be expressed as a stated price, together with accrued interest from January 1, 1987 through the settlement date. Thus, if the bond bore interest of 12% and was "issued at par," its aggregate purchase price would actually be \$1,005 (per \$1,000 of principal), consisting of \* a purchase price of \$1,000 and accrued interest of \$5 (assuming 30-day months). The first interest payment of \$60 on July 1, 1987 would be treated as a payment of interest of \$55 and a return of the accrued interest amount of \$5 (see section 1.61-7(c)).

While not entirely clear, the Proposed Regulations apparently take the position that the "issue price" of the bond in the example above is \$1,005 (i.e., the issue price includes the \$5 of accrued interest) and that the first interest payment consists of qualified periodic interest of \$55 and a \$5 payment included in the stated redemption price at maturity.<sup>31</sup> The bond would not have OID as a result of the accrued interest feature because the accrued interest would be included in both the issue price and the stated redemption price at

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<sup>31</sup> Section 1.1272-1(k), Example (6), considers a bond having a principal amount of \$75,000 that is purchased at original issue for cash of \$68,088.77 on November 19, 1985. The bond bears interest at an 8% rate payable quarterly (i.e., interest of \$1,500 is paid at the end of each quarter including December 31, 1985). According to the example, because the period from the issue date to the first interest payment date is a short period, the first payment of interest on December 31, 1985 consists of qualified periodic interest only to the extent of \$696.30, representing 8% interest from November 19, 1985 through December 31 computed under the exact method in section 1.1272-1(c)(2)(ii)(B). (Presumably, the approximate method or any other reasonable method also could be used in accordance with section 1.1272-1(c)(2)(ii).) The balance of the payment (\$803.70) is included in the stated redemption price at maturity.

In practice, it is likely that the \$68,088.77 purchase price for the bond would be stated as a purchase price of \$67,285.07 plus accrued interest from July 1, 1985 of \$803.70 (assuming accrued interest is calculated under the exact method). Disregarding the OID rules, the accrued interest would be recognized for tax purposes as a separate item. The first interest payment would be treated as consisting of a \$696.30 payment of interest income, and a non-taxable payment of \$803.70 representing a return of the portion of the purchase price allocable to accrued interest. The same practical result would be achieved under Example (6) by including the amount paid on account of accrued interest in the issue price of the bond and treating the portion of the first interest payment that is not qualified periodic interest as an amount included in the stated redemption price at maturity.

maturity. Nonetheless, the rationale for, in effect, offsetting the \$5 of accrued interest paid against the accrued interest received on the first payment date would be restated in terms of the OID rules.

If a bond has OID, inclusion of accrued interest in the issue price and in the stated redemption price at maturity would decrease slightly the yield maturity of the bond, as compared with an approach that treats accrued interest paid and accrued interest received separately from the bond and therefore ignores those amounts for purposes of calculating yield. We believe that taking account of both amounts in the calculation of yield is consistent with commercial practice and have no objection to that approach. However, we recommend that the Proposed Regulations clarify that the issue price includes amounts paid on the issue date that are designated as accrued interest.

If a publicly offered issue of obligations is not sold in its entirety to investors on the issue date, then the amounts paid by investors to purchase the obligations on subsequent dates would ordinarily include accrued interest from the issue date through the date of settlement of their purchases. The increase in the purchase price of publicly offered debt instruments that is attributable to the addition of accrued interest for periods after the issue date would not result in a different issue price for later purchasers under the definition of issue price in section 1.273-2(b)(1)(i). We believe that such purchasers should be permitted to

offset the additional amount of accrued interest which they have paid against qualified periodic interest that is paid on the first payment date, as under current law. The Proposed Regulations should confirm that no change was intended in the treatment of accrued interest that is not included in the issue price.

D. Issue Price.

Section 1.1273-2 defines the term "issue price." The definition differs depending on whether a debt instrument is or is not "publicly offered." According to section 1.1273-2(a)(2), an issue of debt instruments is publicly offered if it (i) is registered with the SEC, (ii) would be required to be registered but for the identity of the issuer or (iii) is exempt from registration under section 3 of the Securities Act of 1933.<sup>32</sup> This definition is troublesome because it fails to limit the requirement for SEC registration to an initial offering (although this is probably implied), does not include publicly offered Eurobonds and includes all securities exempt under section 3 (e.g., bank securities or municipal bonds), regardless of whether they are privately placed or publicly offered. We recommend that the definition be revised to state that an issue of debt instruments is publicly offered if the initial offering of such issue would be required to be registered under

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<sup>32</sup> In order to complete the link between individual debt instruments and a publicly offered "issue" of debt instruments, the definition should state that a debt instrument is publicly offered if it is part of an issue of debt instruments that is publicly offered.

the Securities Act of 1933 but for an exemption from such registration (i) under section 3 of that Act, (ii) under any other law because of the identity of the issuer or the nature of the security<sup>33</sup> or (iii) because the issue is intended for distribution to persons who are not United States persons.

Paragraph (c) of section 1.1273-2 deals with debt instruments that are themselves traded or that are issued in exchange for publicly traded property. The paragraph should be expanded to apply to debt instruments issued in exchange for all types of publicly traded property (including, for example, many foreign currencies) and not just stocks or securities. Cf. section 1.1274-1(b)(5). Such regulations are authorized under section 1273(b)(3)(B)(ii) as amended by section 1803(a)(10) of TRA 1986. The fourth sentence of the paragraph states that if a debt instrument is issued in exchange for publicly traded property and the trading of price the property fails to reflect accurately the value of the debt instrument because of extraordinary circumstances such as the existence of control premium or blockage discount, the issue price of the debt instrument will be determined under section 1274. It should be clarified that this sentence does not apply if the debt instrument is itself publicly traded so that the first sentence of the paragraph applies. Also, what if section 1274 does not otherwise apply because of an exception

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<sup>33</sup> This clause would apply, for example, to securities of an issuer (such as the Federal Home Loan Mortgage Corporation) that is exempted from registration under the legislation authorizing its creation.

under section 1274(c)(4) other than the exception for debt instruments exchanged for publicly traded property? The fifth sentence in paragraph (c) states that property will be treated as traded if it is traded on an established securities market on or within 10 trading days after the date it is issued. This sentence should be modified to make it clear that the relevant period is always the 10 trading days after the issue date of the debt instruments for which the issue price is being determined (rather than the issue date of stock or securities for which those debt instruments are exchanged). In any event, the regulation would be clearer if the case where the debt instruments in question are publicly traded, and the case where they are not publicly traded but are exchanged for publicly traded property, were dealt with in separate paragraphs, as in section 1.1232-3(b)(2)(iii). The regulation should also state that where debt instruments are exchanged for publicly traded property, or a publicly traded debt instrument is issued for property, the issue price controls for purpose of determining the amount realized by the person transferring such property and the basis of the property in the hands of the issuer. Cf. section 1.1274-2(a) and section 1.1232-3(b)(2)(iii)(b).<sup>34</sup>

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<sup>34</sup> In addition, where publicly traded property is exchanged for a debt instrument or investment unit, or a publicly traded debt instrument is issued for property, the regulations should be amended to provide that the relevant valuation date is the date on which a contract to issue such debt instrument or unit is entered into, provided such contract fixes the terms of the exchange and is binding on both parties at all times after such date. See 1983 Report at 1010. Cf. section 1.1274-6(e)(1) (applicable Federal rate determined as of the contract date if earlier than the date of the sale or exchange) .

In a number of places, the Proposed Regulations refer to debt instruments "issued for cash or publicly traded property". See, e.g., section 1.1272-1(f)(4)(i) and section 1.1275-4(e)(1). It should be made clear that this reference includes publicly traded debt instruments that are issued for non-publicly traded property. Section 1.1273-2(c)(2)(i) states that in the case of a debt instrument issued after December 31, 1984 that is issued for property, if neither that property nor the debt instrument is publicly traded, and section 1274 does not apply, then the issue price of the debt instrument equals its stated redemption price at maturity. The purpose of this rule is to provide that such an instrument does not have OID. On the other hand, because the stated redemption price at maturity includes all interest that is not qualified periodic interest, the issue price can be substantially in excess of the principal amount. It should be made clear that the amount realized upon the exchange of property for such a debt instrument and the basis of such property to the buyer is not necessarily the issue price of the debt instrument and in particular will be net of stated interest and of any unstated interest determined under section 483.<sup>35</sup>

Section 1.1273-2(d) provides special rules for investment units. It should be made clear that where an investment unit is publicly traded or issued in exchange for publicly traded property, the issue price of the

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<sup>35</sup> Another situation where application of the definition of stated redemption price at maturity to debt instruments subject to section 483 may cause confusion relates to the effect on such instruments of the market discount rules. See part III.13.F. below.

investment unit is determined in the same manner as if it were a debt instrument. See section 1273(c)(2)(A) and cf. section 1.1232-3(b)(2)(iii).

Where neither the debt instrument nor the property right included in an investment unit is publicly traded, section 1.1273-2(d)(1)(iv) requires that the issue price of the debt instrument be determined based on the original yields of other debt instruments with similar maturities and security issued within the previous six months by the issuer. If no such debt instruments were issued, the issuer and holder may look to comparable debt instruments of other issuers. We question whether the first point of reference should be to original yields of other debt instruments of the issuer issued within the past six months. As recent experience has shown, interest rates can move over a wide range in a six-month period. Surely, if the issuer has outstanding a class of debt instruments that is publicly traded, current yields of those instruments, with some adjustment to account for differences between those instruments and the ones that are part of the investment unit, would be a better measure of an arm's length rate. Where no such class of debt instruments exists, we recommend that the regulation state that an adjustment should be made to the original yields of the recently issued comparable securities of the issuer to reflect

changes in market interest rates since the dates of issuance of those securities.<sup>36</sup> This could be done by determining the spread between the original yield of the comparable securities and the applicable Federal rate for the month in which the instrument was issued (or contracted to be issued with a firm price) and adding that same spread to the applicable Federal rate for the month in which the investment unit is issued (or contracted to be issued with a firm price).<sup>37</sup>

If neither the property right nor the debt instrument portion of an investment unit is publicly traded, both section 1.1232-3(b)(2)(ii)(b) and section 1.1273-2(d)(1)(iv) permit the parties to agree on the issue price for the debt instrument, but the existing regulations accord greater respect to the parties' agreement. They generally presume an issue price to be correct as long as (i) it is based on "arm's length negotiations between parties having adverse interests" and (ii) it reflects an interest rate no more than 1% higher than the actual rate of interest payable on the debt instrument. In contrast, although the relevant statutory language is unchanged,<sup>38</sup> the Proposed Regulations provide neither for any general presumption of correctness of a contractual allocation, nor for any

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<sup>36</sup> It is possible that such an adjustment would be permitted under section 1.1273-2(d)(1)(iv) as now written, given that the issue price of the newly issued debt instrument is only required to be "based on" the original yields of previously issued debt instruments.

<sup>37</sup> In each case, the applicable Federal rate should be the current rate for the month in question, not the lowest rate for the three-month period ending with that month.

numerical safe harbor, instead providing only that in no event may the agreed yield be less than the applicable Federal rate on the issue date. While we would not argue strongly for a numerical safe harbor, we believe that the regulations should provide a presumption of correctness in a case where parties have made a good faith effort to determine an arm's length price and have adverse tax interests. Cf. Comm. v. Danielson, 378 F.2d 771 (3rd Cir. 1967) (strong proof required for taxpayer to upset contractual allocation between goodwill and covenant not to compete).

Comments on the rule for convertible debt instruments in paragraph (e) may be found in part 111.14. below. Part III.13.B. discusses the rule in paragraph (f) for cash payments incident to lending transactions.

E. Reorganization Exchanges.

Under section 1275(a)(4) and section 1.1275-2(a), a debt instrument exchanged for another debt instrument pursuant to a plan of reorganization takes an issue price equal to the higher of the revised issue price of the old debt instrument or what the issue price of the new debt instrument otherwise would be under section 1273 or 1274, as applicable. This rule places a floor on the issue price of the new debt instrument where the new or old debt instrument is traded at a price below the revised issue price of the old debt instrument or, if section 1274 applies, where the imputed principal amount

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<sup>38</sup> Compare former section 1232(b)(2) with section 1273(c)(2).

of the new debt instrument is lower than the revised issue price. We recommend that the regulations state that the phrase "plan of reorganization" as used in section 1.1275-2(a) has the same meaning as in section 354, except that an exchange would not be considered to be outside of a plan of reorganization because of the failure of a debt instrument to qualify as a "security".<sup>39</sup>

Section 1275(a)(4)(B)(i) states that a debt instrument includes an investment unit, and section 1.1275-2(a)(1) includes a cross-reference to the rules in the Proposed Regulations relating to the allocation of the issue price of an investment unit. While these rules are helpful in a case where an investment unit is issued in exchange for an outstanding debt instrument, the regulations should also deal with the case where a new debt instrument is issued in exchange for an outstanding debt instrument and stock or other property. See 1983 Report at 1002.

The regulations should include rules providing for the carryover of OID following a reorganization exchange. Cf. sections 1.1232-3(b)(1)(iv), -3A(a)(2)(iii) and -3A(d), Example (4). As a mechanical matter, these rules should set the issue price of the new bond by reference to the revised issue price of the old bond

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<sup>39</sup> It is often difficult in practice to determine whether a debt instrument is a "security" and the policy reasons for any form of reorganization exception appear to be unrelated to the tax treatment of exchanging holders. Thus, it is clear that the broader exception for reorganization exchanges in old section 1232(b)(2) applied to exchanges that were fully taxable to the exchanging holders (because they received debt in exchange for stock). See, e-g., Revenue Ruling 77-415, 1977-2 C.B. 311.

(rather than carrying over the amount of unaccrued OID). The OID with respect to the new bond might be lower than the OID with respect to the old one if, for example, the new bond had a higher stated rate of interest and a lower principal amount.

The determination of the issue price of debt issued in a debt-for-debt exchange may also affect the extent to which the issuer recognizes cancellation of indebtedness income as a result of the exchange. Take for example, a corporation that has outstanding a \$1,000 face amount bond, which was issued at a discount and has a revised issue price of \$800. The bond has a fair market value of \$400. The corporation exchanges a new \$1,000 face amount bond with a \$400 fair market value for the old bond. Under section 1275(a)(4), the issue price of the new bond is \$800. Does the corporation recognize any cancellation of indebtedness income?

Under section 108(e)(3), there should be no cancellation of indebtedness income since the new bond has initially the same revised issue price as the old bond. The regulations should state that there is no cancellation of indebtedness income in the above situation.

F. Debt Instruments Distributed on Stock.

We recommend two changes relating to section 1275(a)(5) and section 1.1275-2(c), which deal with debt instruments issued and distributed by a corporation with

respect to its stock.<sup>40</sup> In general, such a debt instrument is treated as if it had been issued by the corporation for property.

First, section 1.1275-2(c) should state that where a debt instrument is distributed either pro rata to stockholders or in a non-pro rata redemption in exchange for non-traded stock, the debt instrument is considered to be issued in exchange for property that is not publicly traded, so that section 1274 generally would apply unless the instrument was itself so traded. This is implied in section 1.1275-2(c)(2), Examples (1) and (2).<sup>41</sup> Second, the definition of issue date in section 1.1275-1(c) should be supplemented to provide that the issue date of a debt instrument distributed by a corporation is the date of the distribution.

## 5. Other Definitions.

### A. Debt Instrument.

The last sentence of the definition of "debt instrument" in section 1.1275-1(b)(1) reads as follows:

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<sup>40</sup> Section 1.1275-2(c)(1) refers to a debt instrument "issued by a corporation with respect to its stock." We recommend that the phrase be replaced with "distributed by a corporation with respect to its stock" to conform to the heading of the section and the language of section 1275(a)(5).

<sup>41</sup> The second example states that the issue price of the \$10,000 bond distributed by the corporation is its imputed principal amount under section 1.1274-4. If this is intended to signify that section 1274 applies, the example should make it clear that none of the exceptions in that section, including the exception for sales involving total payments of \$250,000 or less, is available to the shareholder.

"A debt instrument includes an instrument calling for payments in the form of cash, stock, securities, or any other property (other than a debt instrument issued by the same obligor)." The purpose of this sentence should be clarified. The reference to an instrument calling for payments in the form of stock or other securities has been read by some (improperly, we suspect) as an oblique signal that conversion or exchange rights of the type discussed in part III.14. below should be taken into account, before or upon the exercise of those rights, in applying the OID rules. It seems more likely that the reference was intended to permit the OID rules to apply to transactions in which property is exchanged for non assignable rights to receive contingent amounts of stock or securities, although it appears that better results would be achieved in those transactions if such rights were not characterized as "debt instruments". See part III.8.D. below (contingent stock pay-outs in reorganizations).

The carve out for payments in the form of "a debt instrument issued by the same obligor" also needs further explanation. Presumably, the exception was intended to provide for cases where the distribution of a debt instrument is indistinguishable economically from a change in the terms of a single, continuing debt instrument (or the failure to exercise a right to prepay such an instrument); in those circumstances, the delivery of a new piece of paper to evidence the continuing debt instrument should not be treated as a payment.

One type of transaction where the no payment approach of the regulation is clearly appropriate is a so-called "baby bond" financing. In a typical arrangement, the issuer of a bond ("parent bond") retains, as one of the terms of the parent bond, the option to distribute another identical bond ("baby bond") in lieu of a cash payment of interest on the parent bond. The rate of exchange between baby bonds and cash is fixed. It is our understanding that bonds of this type would be treated as follows under the Proposed Regulations: The distribution of the baby bonds would not be treated as a payment on the parent bonds. Instead, a parent bond and any baby bonds distributed thereon would be analyzed as a single debt instrument that was issued on the issue date of the parent bond, at a price equal to the issue price of the parent bond, and provides for unconditional cash payments only at maturity (or on any earlier payment dates on which there is no option to distribute baby bonds instead of cash). The options to pay cash prior to maturity in lieu of distributing baby bonds would be handled in the same manner as other call options under section 1.1272-1(f)(4).<sup>42</sup> There would be no

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<sup>42</sup> To illustrate how the rule would operate in a typical baby bond transaction, suppose that a parent bond is issued on January 1, 1987 for cash of \$1,000. The bond provides for a principal payment of \$1,000 on December 31, 1996 and semiannual interest payments of \$40, payable at the issuer's option either in cash or in \$40 principal amount of baby bonds identical to the parent bond. Because no interest is unconditionally payable on the bonds prior to maturity, none of the interest thereon is qualified periodic interest. Accordingly, all interest income on the bonds would be treated as OID. Such OID would accrue, under section 1.1272-1(f)(4), based on the lowest possible yield of the bonds that the issuer can achieve by exercising, or failing to exercise, each of the cash payment options. That yield would be 8%. If on any  
(footnote continued)

practical need to distinguish between the parent bond and the baby bonds unless one was sold without the other. In that event, because the parent bonds and baby bonds are identical, the revised issue price and adjusted tax basis of the parent bond and baby bonds together would be allocated between the bonds that are sold and those that are retained in proportion to their principal amounts. Gain or loss would be recognized equal to the difference between the amount realized in the sale and the allocated basis. No other special tax issues would arise as a result of the sale. The sale would represent only a sale by a holder of a single class of identical securities of a portion of his holdings. We recommend that the treatment of baby bond transactions described above be confirmed in the final regulations, perhaps through an example.

While the no payment approach accurately reflects, in our view, the economic terms of a baby bond transaction, it also produces an important practical benefit. The benefit is that the parent bonds and baby bonds have identical tax characteristics and therefore are fungible for trading purposes. This would not be the

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payment date a cash payment was made on a bond, that payment would be credited against the accrued OID on the bond and would reduce its adjusted issue price. On the other hand, if a baby bond was distributed, the distribution would have no immediate tax consequences and the revised issue price of the bond on which the distribution was made, and its adjusted tax basis to the holder, would be allocated between that bond and the baby bond in proportion to their respective principal amounts. Thereafter, OID would accrue on both bonds based on an 8% yield. In the example, the revised issue price of a parent or baby bond would at all times equal its principal amount plus the stated amount of accrued and unpaid interest thereon.

case if each baby bond was considered to be issued when it was actually distributed.

The analysis would be more complex in a transaction that is similar to a baby bond financing as described above except that the baby bonds have economic terms different from the parent bond. It would still seem to be appropriate to analyze the parent bonds as if they incorporated the payment terms of the baby bonds but provided for issuer call options. Thus, the distribution of a baby bond would not have any income tax consequences. On the other hand, a sale of one or more, but not all, of a parent bond and the baby bonds that have been distributed thereon could no longer be analogized to a sale of a pro rata share of an investor's holdings of a single debt instrument; rather, the sale would be a "stripping" transaction that would result in the application of section 1286.

If the right to distribute a debt instrument in respect of another outstanding debt instrument is not provided for in the terms of the original debt instrument, then the regulation should not apply to treat the new debt instrument as a continuation of the old one. Otherwise, the regulation would swallow up the rules governing debt-for debt exchanges in recapitalizations, which was presumably not intended.

B. Issue Date.

Section 1275(a)(2)(A) defines the term "date of original issue" for publicly offered debt instruments as "the date on which the issue was first issued to the public." Section 1.1275-1(c)(1) states that, in the case of such instruments, the "issue date" is the "settlement date." In order to ensure that an issue of obligations has only one issue date and to clarify the meaning of "settlement date," we recommend that the definition be revised to state that the issue date for an issue of publicly offered debt instruments is "the first settlement date for the purchase from the issuer of debt instruments included in that issue."

C. Tax-Exempt Obligations.

Section 1.1275-2(d) defines the term "tax-exempt obligation" to mean a debt instrument with respect to which all of the interest (i) is not includible in gross income under section 103, or (ii) is exempt from tax (without regard to the indentivity of the holder) under any other provision of law. Presumably the reference to interest "exempt from tax" means exempt from federal income tax. This understanding should be made explicit. Moreover, in view of TRA 1986, the regulations should state that an obligation will be considered to be "tax exempt" even though it is subject, directly as a private activity bond issued after August 7, 1986 or indirectly because of the book income tax preference item, to the federal alternative minimum tax. Cf. section 59(i), added by TRA 1986.

D. Revised Issue Price.

The definition of "revised issue price" should be amended to take account of payments, in partial retirement of a debt instrument, of amounts included in the stated redemption price at maturity of the instrument. This would conform the definition to the definition of adjusted issue price (which is also in need of amendment as discussed in part III.6. below).

6. Installment Obligations/Aggregation Rule.

A. Introduction.

A debt obligation may provide for a single payment of principal at maturity, or principal may be payable in installments. Typically, interest on an installment obligation is calculated by applying a specified rate to the outstanding principal balance so that interest is reduced proportionately as principal payments are made.

Each scheduled payment of principal on an installment obligation, and the interest thereon, could be thought of as a separate debt obligation ("Serial Bond"). Each Serial Bond would mature on the date when the related principal payment is due and have its own stated redemption price at maturity and issue price (and hence, OID).

The OID rules could be applied to an installment obligation simply by aggregating the OID and other income and deductions that would be reported with respect to each of the Serial Bonds comprising the obligation if they had been separately issued. Alternatively, a special regime could be developed for installment obligations that would treat them as a single, indivisible debt instrument. For convenience, the former approach will be referred to as the "serial bond approach" and the latter as the "single bond approach". Generally, the section 1232 regulations follow the serial bond approach whereas the Proposed Regulations follow a single bond approach.

The serial bond approach is supported by a simple syllogism: (i) interest is associated economically with a stated amount of principal; (ii) discount is the same as interest, the only difference being that discount is paid in full even if principal is prepaid; (iii) therefore, discount should be assigned to a stated amount of principal (in a manner consistent with its role as a surrogate for interest) and should be considered to be paid when that principal is paid.

Two other results follow directly from the notion that an appropriate amount of discount should be permanently assigned to each principal payment. If the only discount associated with an installment obligation is OID, then no discount income should be reported when a scheduled payment of principal is made because the full amount of OID associated with that principal should already have been accrued and included in income. On the

other hand, if principal is prepaid, the unaccrued OID associated with the prepaid principal should be taxable at that time. If principal is prepaid, a method must be devised to calculate the amount of unaccrued discount associated with the prepaid principal amount. At least in one case, the choice of a method is obvious. If the effect of the prepayment is to reduce proportionately each and every future principal installment, then in effect a pro rata slice of the entire obligation has been retired and a pro rata portion of the unaccrued discount for the entire obligation should be considered to be paid.

The results obtained under the section 1232 regulations were consistent with the principles set forth in the two preceding paragraphs and we believe that the same should hold true under any new approach that is adopted. To do otherwise would disregard the economic function of discount as a charge for the use of money.

The report summarizes below the competing approaches to installment obligations in the section 1232 regulations and in the Proposed Regulations, and then discusses the consequences of choosing one over the other.

B. Description of Current and Proposed Regulations.

(a) Current Regulations.

Section 1.1232-3(b)(2)(iv) reads as follows:

Serial obligations - (a) In general. If an issue of obligations which matures serially is issued by a corporation, and if on the basis of the facts and circumstances in such case an independent issue price for each particular maturity can be established, then the obligations with each particular maturity shall be considered a separate series, and the obligations of each such series shall be treated as a separate issue with a separate issue price, maturity date, and stated redemption price at maturity. The ratable monthly portion of original issue discount attributable to each obligation within a particular series shall be determined and ratably included in gross income under the rules of § 1.1232-3A.

(b) Issue price not independently established.

If a separate issue price cannot be established with respect to each series of an issue of obligations which matures serially, the issue price for each obligation of each series shall be its stated redemption price at maturity minus the amount of original issue discount allocated thereto in accordance with (d) of this subdivision [a bond-years method]. The amount of original issue discount so allocated shall be ratably included as interest in gross income under [the] rules of § 1.1232-3A.

(c) Single obligation rule. If a single corporate obligation provides for payments (other than payments which would not be included In the

stated redemption price at maturity ...) in two or more installments, the provisions of (b) of this subdivision shall be applied by treating such obligation as an issue of obligations consisting of more than one series each of which matures on the due date of each such installment payment.

This regulation quite clearly follows the serial bond approach. In the case of "an issue of obligations which matures serially" (which presumably refers to an issue consisting of separately assignable classes of debt instruments, each having a different maturity), as well as in the case of a single installment obligation, the principal payments due at one time, and related interest, are treated as separate obligations having an amount of OID that is included in income under the normal rules for obligations having a single principal payment.

The only difference between the treatment of separately assignable serial obligations and installment obligations relates to the ability to establish independent issue prices. If independent issue prices can be established for the separately assignable serial obligations of each maturity, then those issue prices will control.<sup>43</sup> Otherwise, a mechanical formula (bond-years method) is applied to allocate discount for the entire issue among the obligations of each maturity. By

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<sup>43</sup> Where serial obligations are issued to different investors, either in a public offering or private placement, the actual offering prices or purchase prices would presumably establish "independent" issue prices for each maturity. However, an issuer is not precluded under the regulation from establishing independent issue prices in other circumstances.

contrast, the regulation assumes that independent issue prices cannot be established for individual principal payments on a single installment obligation (presumably because those payments are not separately assignable), so that the allocation formula must be applied to those payments in all events.

The 1983 Report did not reexamine the wisdom of the serial bond approach reflected in the foregoing regulation, but did recommend (at 1009) that the regulation be amended to allocate OID among the obligations of each maturity, in circumstances where independent issue prices could not be, or were not permitted to be, established, under a constant yield method rather than a bond-years method. The change was needed to conform the allocation rule to the compounding-of-interest principles underlying the TEFRA amendments.<sup>44</sup>

(b) Proposed Regulations.

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<sup>44</sup> In the case of an installment obligation, the OID that would be allocable to each Serial Bond under a constant yield method would equal the excess of (i) the stated redemption price at maturity of the Serial Bond over (ii) its present value as of its issue date, calculated using a discount rate equal to the original yield to maturity of the installment obligation as a whole. It was noted in the 1983 Report at 1010 that this method could be criticized on economic grounds in that it would apply the same discount rate to payments regardless of when they were due (thereby disregarding the effect of a rising "yield curve"), but a horizontal "yield curve" was thought to be a necessary simplifying assumption. It may also be noted that a conventional bond provides for payments at different times over its life (albeit payments of interest and not principal) and yet no attempt is made for tax purposes to break the bond up into individual payments that mature at different points along the yield curve.

The Proposed Regulations seemingly break new ground by rejecting the serial bond approach in favor of the single bond approach. The only reason given for the switch is the statement in the preamble to the Proposed Regulations that "the OID rules now apply to a much broader class of obligations, including mortgages involving as many of 360 separate payments of principal." The statement implies that the drafters were concerned primarily with problems of administration. This view is supported by the fact that the substantive changes in the Proposed Regulations could have been accomplished without abandoning the serial bond approach, as discussed below. Moreover, we believe that the economic function of discount as a surrogate for interest severely limits the extent to which results differing from those achieved under the serial bond approach can be tolerated.

The heart of the proposed new regime is section 1.1275-2(d), which generally requires the aggregation of all debt instruments issued in one transaction and of all payments on a single installment obligation:

(d) (1) Aggregation of debt instruments--general rule. All debt instruments, whether or not issued for property, issued in connection with the same transaction or a series of related transactions or as part of the same issue shall be treated together as a single debt instrument with a single issue price, maturity date, yield, and stated redemption price at maturity for purposes of sections 1271 through 1275 and the regulations there under, except as provided

in paragraph (d)(2) of this section. A single installment obligation (as defined in § 1.1273-1(b)(Z)(i)) shall be subject to the rule described in the preceding sentence. Whether debt instruments are issued in connection with the same transaction or a series of related transactions shall be determined in accordance with all the facts and circumstances surrounding the issuance of the debt instrument. See § 1.1274A-1(d).

(2) Exception. Paragraph (d)(1) of this section shall not apply if --

(i) Each debt instrument held by the taxpayer is part of a series that is separately traded on an established securities market, or

(ii) (A) Each debt instrument held by the taxpayer is issued in exchange for property; (B) each instrument calls for interest at the lowest rate (or fixed multiple thereof) that constitutes adequate stated interest within the meaning of section 1274(c)(2) and 5 1.1274-3; and (C) all interest under each debt instrument is qualified periodic interest within the meaning of § 1.1273-1(b)(1)(ii).

An example accompanying this Proposed Regulation (in paragraph (d)(4)) shows that if non-traded property is sold in a transaction subject to section 1274 in exchange for two debt instruments, a two-year instrument bearing interest at a rate of 20% and a ten-year instrument bearing interest at a rate of 10%, then the

aggregation rule would require the two instruments to be treated as a single instrument that has a common yield representing a blend of the two rates. Although each note has a rate of interest not less than the assumed applicable Federal rate (8% for the two-year note and 10% for the ten-year note), because the rates of interest on the notes are not equal to, or the same multiple of, the applicable Federal rates for the two notes, the exception in paragraph (d)(2)(ii) does not apply.

The result in the example is not surprising. A higher interest rate for the shorter-term note conflicts with the normal expectation of a rising "yield curve." Therefore, giving effect to the "step-down" in interest rates arising from the use of two separate notes would artificially accelerate interest deductions of the borrower. On the other hand, the parties would have been free under the Proposed Regulation to defer income of the seller, and deductions of the buyer, by providing for separate shorter and longer-term notes having rates of interest paralleling the rise in the applicable Federal rates.

Once the serial bond approach has been discarded as an analytical tool in calculating OID, a need arises for special rules governing installment obligations. This point did not escape the drafters of the Proposed Regulations and they responded with new definitions and with rules (among others) for determining the adjusted issue price, the de minimis amount of OID and the applicable Federal rate. These last two items are

considered in part III.4.A. above and part III.10.F. below.

The new definitions are found in section 1.1273-1(b)(2). Section 1.1273-1(b)(2)(i) defines an "installment obligation" as "a debt instrument providing for the payment of any amount other than a qualified periodic interest payment . . . before the final maturity date of the instrument."<sup>45</sup> Paragraph (b)(2)(ii) adds that the stated redemption price at maturity of an installment obligation is "the total of all payments provided by the obligation other than qualified periodic interest payments." Finally, paragraph (b)(2)(iii) creates a subcategory of installment obligation, the "self-amortizing installment obligation." As the name implies, an obligation of this type is a level payment obligation such as a typical residential mortgage.<sup>46</sup>

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<sup>45</sup> Thus, as is true under section 1.1232-3(b)(2)(iv)(c), no distinction is drawn between an obligation that provides for more than one payment of principal and one that has a single payment of principal and interest that is not qualified periodic interest.

<sup>46</sup> More particularly, the definition is "an installment obligation that calls for equal payments of principal and qualified periodic interest that are actually and unconditionally payable (or that will be treated as constructively received under section 451 and the regulations there under) at fixed periodic intervals of one year or less during the entire term of the obligation, with no additional payment required at the maturity date of the obligation other than a de minimis amount to adjust for rounding, the timing of payments and similar circumstances." Since all interest on a self amortizing installment obligation is by definition qualified periodic interest, the stated redemption price at maturity of such an obligation should equal its principal amount, as paragraph (d)(2)(iv) confirms.

Turning from definitions to more substantive rules, a special definition of adjusted issue price for installment obligations is found in section 1.1272-1(e)(2)(ii). The definition follows the general definition in paragraph (e)(2)(i) (issue price increased by accruals of OID) except that it provides for a dollar-for-dollar reduction in the adjusted issue price for the amount of any payment that is not qualified periodic interest. (The factor that distinguishes an installment obligation from other obligations is, of course, that payments other than payments of qualified periodic interest are made prior to maturity.) The special definition of adjusted issue price concludes with the following:

Each payment other than a payment of qualified periodic interest shall be treated first as a payment of original issue discount to the extent accrued as of the date of the payment and not allocated to prior payments, and second as a payment of principal (and no portion thereof shall be treated as prepaid interest).

One curious feature of the special rule for determining the adjusted issue price installment obligations is that it does not account for the possibility that a principal payment can result in gain (i.e., prepayments are ignored). The same is true of the rule for basis found in section 1.1272-1(j).

C. Comments.

(a) General.

In order to evaluate the switch in approaches between the section 1232 regulations and the Proposed Regulations, the substantive consequences of the change must be understood. These may be grouped under four headings: (i) short-term obligations, (ii) accruals of OID, (iii) effect of scheduled payments and prepayments of amounts included in the stated redemption price at maturity, and (iv) implications for the reporting of market discount. Each of these topics will be considered in turn, followed by a few more technical comments on the new rules.

(i) Short-term obligations. Subject to section 1281, it is not generally necessary to accrue OID with respect to a debt obligation having a term to maturity of one year or less ("short-term obligation"). See section 1272(a)(2)(C). Moreover, there is no effective de minimis rule for short-term obligations because the de minimis amount under section 1273(a)(3) (number of complete years to maturity times .25%) is zero. Also, the definition of "registration-required obligation" in section 163(f)(2) excludes short-term obligations.

A question under the section 1232 regulations is whether the fictional separate identity of each of the Serial Bonds comprising an installment obligation implies that Serial Bonds maturing within a year of the issue date would be governed by the rules applicable to short-term obligations. Adoption of the single bond approach in the Proposed Regulations places to rest this concern and is a welcome development. Little would be gained, other

than an even greater sense of malaise over the complexity of the Code, by subjecting the component parts of a single debt instrument to different tax regimes.

Resolution of this problem, however, does not require adoption of the single bond approach. Although there is some doubt whether a Serial Bond due within one year would be treated as a short-term obligation under the existing regulations, it would, of course, have been possible to resolve this issue directly without abandoning the serial bond approach.

(ii) Accruals of OID. One important implication of the single bond approach is that the yield to maturity that is used in calculating accruals of OID on an installment obligation is always the yield to maturity of the entire obligation, calculated by comparing its aggregate issue price with all payments to be made thereon. Thus, the yield will not change as principal installments are paid, a result that is consistent with the statement in section 1.1272-1(f)(1) that "[y]ield is determined on the issue date of the debt instrument and, except in the case of a variable rate debt instrument described in § 1.1272-5, remains constant over the term of the debt instrument." The same numerical results could have been reached under the serial bond approach if OID were allocated among Serial Bonds in the manner proposed in the 1983 Report at 1009-1010 (based on present values using the yield to maturity of the overall installment obligation as the discount rate). Nonetheless, describing the method of calculation of accruals of OID without

referring to Serial Bonds may be easier to understand and apply.

As noted above, in the case of an issue of separately assignable serial obligations, the section 1232 regulations allow an independent issue price to be used in calculating OID for obligations of each maturity if independent issue prices can be established. The Proposed Regulations make two significant changes here. First, they permit an independent issue price to be used for two or more series of obligations only if the different series are separately traded on an established securities market. Thus, apparently, other evidence of the independent value of each series will not be accepted. In addition, the rules for serial obligations, which apply in section 1.1232-3(b)(2)(iv)(c) of the current regulations to "an issue of obligations," has been extended to all obligations that are issued, very generally, in a single transaction. We have some technical comments on these changes below.

Neither of these two changes requires adoption of a single bond approach. Nonetheless, we recognize again some potential advantages in terms of convenience (including drafting convenience) of a single bond approach, particularly when applying the OID rules to obligations subject to section 1274.<sup>47</sup>

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<sup>47</sup> Where property is exchanged for two or more notes to which section 1274 applies, there is no aggregate issue price determined apart from section 1274 that can be allocated among the separate notes. Instead, the rules of section 1274 must first be applied to determine an issue price and in some

(footnote continued)

(iii) Treatment of scheduled payments and prepayments. How are scheduled payments and prepayments to be handled under the single bond approach? Examples in the Proposed Regulations indicate that gain or loss is

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(footnote continued from previous page)

situations (such as the example at section 1.1275-2(d)(4)) the terms of all of the notes must be taken into account. Thus, it may be easier, as a drafting matter, to apply section 1274 to multiple notes by treating all payments on the notes as if they were made under a single debt obligation (with the one exception set forth in section 1.1275-2(d)(2)(ii)).

not recognized by the original holder of an installment obligation when scheduled payments included in the stated redemption price at maturity are received (section 1.1272-1(k), Examples (8)-(10)). However, the Proposed Regulations do not explain how this result is reached under the single bond regime. Moreover, they give no direct guidance as to the treatment of prepayments. In exploring how scheduled payments and prepayments would be treated under the single bond approach, it will be helpful to refer to a simple installment obligation.

The obligation has an initial principal amount of \$1,000 and provides for one payment of principal of \$500 after five years and a second payment of \$500 after ten years. Assume that the obligation bears interest at a rate of 8%, payable semiannually, and is issued at a price of \$811.70 to yield 12% (with semiannual compounding). The effect of scheduled payments on this obligation will be addressed first, followed by an analysis of prepayments.

(a) Effect of scheduled payments. Assume that \$500 is paid when due at the end of the fifth year. What gain or loss, if any, would be recognized by an original holder of the obligation who receives that \$500 payment?

If the bond were analyzed as two \$500 Serial Bonds, and the issue price of each Serial Bond were determined by reference to the yield to maturity of the bond as a whole, then the issue price of the Serial Bond representing the first \$500 principal payment would be

\$426.40 (the present value of a \$500 principal payment due in five years and interest at 8% using a discount rate of 12%, compounded semiannually), reflecting OID of \$73.60, and the issue price of the second Serial Bond determined in the same manner would be \$385.30, reflecting OID of \$114.70. Total OID for the two Serial Bonds would be \$188.30. At the end of five years, the full \$73.60 of OID allocable to the Serial Bond due at that time would have been included in income. Accordingly, when the \$500 payment is made at the end of the fifth year, that payment would be allocated \$426.40 to the issue price of the first Serial Bond and \$73.60 to the accrued OID with respect to that obligation, resulting in no gain or loss. Under the serial bond approach, no portion of that \$500 payment would be considered attributable to the second Serial Bond.

If the \$500 principal payment at the end of the fifth year is analyzed under the single bond approach of the Proposed Regulations, without reference to any Serial Bonds, what is the result? A single adjusted issue price would be calculated for the obligation under section 1.1272-1(e)(2)(ii) and would equal, immediately prior to the payment of the first scheduled principal installment, \$926.40 (the issue price of \$811.70 plus accrued OID of \$114.70). The last sentence of section 1.1272-1(e)(2)(ii), which is quoted above, would require that the \$500 payment be treated first as a payment of OID to the extent accrued as of the date of the payment and not allocated to prior payments (\$114.70), and second as an additional payment of "principal" (\$385.30). No gain or

loss is recognized on account of the payment of accrued OID, but what are the consequences of the additional principal payment?

Immediately prior to the first \$500 principal payment, the aggregate outstanding principal balance of the obligation is \$1,000 and its tax basis in the hands of the original holder is \$926.40, reflecting a potential gain of \$73.60. If the single bond approach were thought to require that no distinction be drawn between different principal payments on an obligation, then one might simply allocate this gain pro rata among all principal amounts and therefore require that the holder recognize gain of \$36.80 (half of \$73.60), or, possibly, if the payment of accrued OID is subtracted first, of \$32.03 ( $385.30/885.30$  times 73.60). These results are obviously not correct. No gain should be recognized as the result of the making of scheduled payments.

One way to achieve the desired result without referring to serial bonds would be to think of the installment obligation as being represented for tax purposes by two separate accounts -- an adjusted issue price account (the balance of which is simply the adjusted issue price) and an unaccrued OID account. At any time, the sum of these accounts would equal the stated redemption price at maturity of the outstanding obligation. Each payment on the obligation that was included in the stated redemption price at maturity would be allocated between these accounts and would reduce the account to which it was allocated. To the extent a

payment was allocated to the adjusted issue price account, no gain would be recognized as a result of the making of the payment. Accrued OID would, of course, be reflected in the adjusted issue price account so that amounts representing payments of accrued OID would be charged against that account. On the other hand, a payment would be treated as gain from the retirement of the obligation to the extent allocable to the unaccrued OID account. Therefore, scheduled payments would not result in gain or loss unless they were allocated in part to the unaccrued OID account. The rule for allocating payments between the adjusted issue price account and the unaccrued OID account can be derived from the principle of the Proposed Regulations that yield remains constant over the life of a debt obligation. The yield to maturity of a debt instrument is calculated as the yield that when used to discount all scheduled future payments causes their present value on the issue date to equal the issue price. In order for the yield of a debt instrument to remain equal to that initial yield to maturity over its entire life, the adjusted issue price of the obligation must equal on each payment date the present value of all future scheduled payments calculated by using that initial yield to maturity as the discount rate. Therefore, the portion of a principal payment chargeable against the adjusted issue price account should equal the excess of (i) the balance of the account immediately before the payment over (ii) its balance immediately thereafter, which would equal the present value of future scheduled payments. The excess of the payment over the

amount debited to the adjusted issue price account would be allocable to unaccrued OID.

Applying this analysis to the obligation above, the adjusted issue price of the obligation immediately following the making of the first \$500 payment must equal \$426.40 (the present value at that time of the second \$500 payment and related interest using a discount rate of 12%). Since the adjusted issue price of the obligation immediately before the making of the payment was \$926.40, this result can be achieved only by allocating the \$500 payment solely to the adjusted issue price account, and doing so implies that no gain or loss is recognized by the holder. The same result would obtain for any scheduled payment.

(b) Prepayments. Suppose that a principal payment of \$750 is made at the end of the fifth year on the installment obligation described above. This payment consists of the scheduled principal payment of \$500 and a prepayment of half the principal scheduled to be paid there-after. Under the serial bond approach, the holder would recognize, as a result of the prepayment, gain of \$36.80, which represents half of the unaccrued OID with respect to the Serial Bond that is prepaid.

Under the last sentence of section 1.1272-1(e)(2)(ii), the \$750 payment would be treated first as a payment of accrued OID in the amount of \$114.70 and then as an additional principal payment in the amount of \$635.30. If gain from the receipt of this payment were

calculated as a pro rata share of the unaccrued OID on the instrument immediately prior to the making of the payment, then the holder would recognize gain of \$55.20 (75% of \$73.60), or, possibly, \$52.82 ( $635.30/885.30$  times 73.60), which again are clearly erroneous results.

Applying the alternative two account analysis described above, the portion of the \$750 payment allocable to the adjusted issue price account would equal the excess of the adjusted issue price of the obligation immediately prior to the making of the payment (\$926.40) over the present value (immediately thereafter) of the \$250 payment remaining to be made (\$213.20), or \$713.20. Thus, the amount allocated to the unaccrued OID account, and the amount of gain recognized, would be the excess of \$750 over \$713.20, or \$36.80, the same amount derived under the serial bond approach.<sup>48</sup>

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<sup>48</sup> In the examples above, the reduction in the adjusted issue price resulting from a payment calculated under the two account approach was not less than the portion of that payment that would be treated as a payment of accrued OID under the rule in the Proposed Regulations that allocates payments of amounts included in the stated redemption price at maturity first to accrued OID. Where this is not the case, the two account approach would directly conflict with that rule. To illustrate, suppose that a prepayment of \$50 is made on the installment obligation described in the text at the end of the fourth year and that the prepayment reduces all future principal installments proportionately (so that after giving effect to the prepayment the amount due at the end of years five and ten is reduced to \$475). Immediately before the \$50 payment is made, the adjusted issue price of the installment obligation is \$897.83, reflecting accrued OID of \$86.13 and unaccrued OID of \$102.17. If the \$50 prepayment is credited first against accrued OID, as required under the Proposed Regulations, then no gain would be recognized because of the prepayment. On the other hand, under both the serial bond approach and the two account method, the prepayment would result in gain equal to 5% of the

(Footnote continued)

(c) Recommended amendment to section 1.1272-1(e)(Z)(ii). In order to account properly for scheduled payments and prepayments, the special definition of adjusted issue price applicable to installment obligations should be amended. The amendment would provide that (i) scheduled payments of amounts other than qualified periodic interest will be subtracted dollar-for-dollar from the adjusted issue price and will not give rise to gain attributable to unaccrued OID and, (ii) prepayments of such amounts (defined as payments made before the beginning of the accrual period in which they are due) will be subtracted from the adjusted issue price in an amount such that the adjusted issue price immediately following such subtraction will equal the present value (as of the beginning of the next accrual period following the prepayment) of all future remaining scheduled payments after giving effect to the prepayment, calculated using the yield to maturity of the obligation as the discount rate. The holder would recognize gain attributable to unaccrued OID equal to the excess of the amount of the prepayment over the reduction in the adjusted issue price.<sup>49</sup> The basis rule in section 1.1272-

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(Footnote continued from previous page)

unaccrued OID or \$5.11. The conflict between the Proposed Regulations, on the one hand, and the serial bond approach and the two account method, on the other hand, is caused by the fact that the reduction in the adjusted issue price under the latter methods (\$44.59), is less than the portion of the payment that is treated as a payment of accrued OID under the Proposed Regulations (\$50). Given the fact that 5% of the obligation has been retired, requiring recognition of gain of \$5.11 is clearly the proper result, so that the Proposed Regulations produce an underreporting of income.

<sup>49</sup> A holder who purchased the obligation with some acquisition premium would reduce the gain by the fraction described in section 1.1272-1(g)(1)(ii).

1(j)), which does not now allow for the possibility that a holder of a debt instrument would recognize gain because of the receipt of payments thereon other than qualified periodic interest, would be amended to take account of such gain.<sup>50</sup>

(iv) Implications for reporting of market discount. Ordinarily, it makes no difference whether a payment on a debt instrument represents a payment of accrued OID or a return of the issue price; in either case, no gain is recognized.<sup>51</sup> Therefore, the rule in the Proposed Regulations treating payments of amounts other than qualified periodic interests as first being a payment of accrued OID makes no difference to the extent the payment would otherwise be a return of the issue

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<sup>50</sup> The amendment described above would not distinguish between principal payments and payments of interest that are not qualified periodic interest. The last sentence of section 1.1272-1(e)(2)(ii) states that payments other than qualified periodic interest shall be credited against accrued OID or principal and adds that "no portion thereof shall be treated as prepaid interest." Presumably even the most intrepid taxpayers would not argue that principal payments are prepaid interest, so that this statement must be directed at payments of interest that are not qualified periodic interest. If such interest payments are prepaid, they would not be treated as prepaid interest since they would have lost their character as interest by virtue of being included in the stated redemption price at maturity. On the other hand, if the prepayment occurred prior to the beginning of the accrual period in which the payment is due, then under either the serial bond approach or the two account approach, the holder would report income equal to the unaccrued OID allocated to the prepaid amount and the issuer would be allowed a corresponding deduction. These results seem appropriate and some clarification of the purpose of the reference to prepaid interest is needed.

<sup>51</sup> It would make a difference where interest deductions are allowed only where OID is actually paid, as is the case for consumer loans under section 1275(b)(2). See part III.13.

price. By contrast, if the discount in question is market discount rather than OID, a rule that treats a payment of principal as a payment in respect of accrued market discount to the extent of the total amount of accrued market discount would have a dramatic effect on the timing of income; this is because market discount, unlike OID, is only taxed when it is received in cash.

Section 1803(a)(13) of TRA 1986 amends section 1276 to provide that a partial principal payment on a market discount bond shall be included in gross income as ordinary income to the extent such payment does not exceed the accrued market discount on the bond.<sup>52</sup> In the case of an obligation that provides for partial principal payments on each payment date, this rule will have the practical effect of obliterating the distinction between market discount and OID. We do not agree that this is a proper result and urge that it be reconsidered.<sup>53</sup>

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<sup>52</sup> While we do not intend to comment exhaustively on the amendment in this report, we note that it does not appear to take account of the possibility that a debt instrument may have both OID and market discount and that a principal payment may be taxable in part as a payment of unaccrued OID. It would not be appropriate to treat a principal payment as a payment of accrued market discount to the extent the payment has already been included **in income** as a payment of unaccrued OID.

<sup>53</sup> We do not object to a rule that treats payments on a loan as interest to the extent of the aggregate amount of accrued interest or OID in circumstances where interest on OID is accounted for under a cash method. See the discussion in part III.11.A. below of the Proposed Regulations under section 446 and the discussion in part III.13.D. below of the treatment by borrowers of OID on consumer loans. In that context, although the accounting method requires that tax consequences be delayed until cash is paid, it is appropriate to characterize payments as interest so as to achieve a result that is as close as possible to a current accrual system. By contrast, the

(footnote continued)

(footnote continued from previous page)

As noted above, discount (including market discount) is economically similar to interest and therefore should be considered to be associated with a given amount of principal.<sup>54</sup> It is misguided, then, to treat a payment of principal as being to any extent a return of accrued discount with respect to other principal payments. Thus, in the case when a prepayment reduces all future scheduled payments on an installment obligation pro rata, the prepayment should result in recognition of a pro rata portion of the accrued market discount, not an amount equal to the lesser of the amount of the payment and the aggregate amount of accrued market discount with respect to the obligation as a whole.

To state the point in more practical terms, why should an investor who purchases an installment obligation that provides for payments after five and ten years be treated differently from an investor who purchases two separate five and ten year obligations

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deferral of taxation of market discount is not based on the absence of cash payments (the same rules for market discount apply to both cash and accrual method taxpayers) but rather on doubt as to whether discount that is not interest from the borrower's perspective should be fully equated to interest or OID, or should instead be treated as a trading gain that is recognized only upon disposition of a debt instrument. Given this difference, we do not believe that there is a logical inconsistency in recommending that different approaches be followed in accounting for market discount and for interest or OID that is reported under a cash method.

<sup>54</sup> This economic similarity may suggest that market discount should be taxed as it accrues in the same manner as OID, but this is not now required. The comments in the text go to the question of how discount should be allocated among principal payments on an installment obligation given the general rule for single payment obligations that defers the taxation of market discount until principal is paid.

(apart from any difference that may arise because of the absence of independent prices for payments that are part of a single installment obligation).<sup>55</sup> Clearly, the purchaser of two separate obligations would not be taxed in respect of any market discount attributable to the ten-year obligation upon maturity of the five-year obligation.

(b) Technical Comments.

(i) It should be made clear that section 1.1275-2(d) will not require the aggregation into a single instrument of debt obligations issued by unrelated borrowers. For example, suppose that a corporation issues debt and loans the proceeds to several borrowers. The

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<sup>55</sup> A rule requiring principal installments to be applied first against market discount would create anomalies in the treatment of mortgage-backed securities. For example, such a rule would create a distinct difference in tax treatment between a single class mortgage-backed bond that is collateralized by a pool of mortgages and subject to prepayment to the extent there are prepayments on the underlying mortgages and an economically similar pass-through security representing an ownership interest in the same pool of mortgages. In the former case, if 10% of the mortgages were prepaid and the principal amount of the mortgage-backed security correspondingly reduced by 10%, then under a "discount first" rule, the holder would recognize discount income up to the lesser of the amount of the payment and the amount of discount accrued with respect to the entire obligation. By contrast, a prepayment of 10% of the mortgages underlying the pass-through security would not result in recognition of an amount of discount income greater than the discount properly allocable to the mortgages that were prepaid. It would not be possible to require recognition of discount income with respect to one mortgage as a result of the receipt of payments on another mortgage without changing the basic framework governing the tax treatment of pass-through securities.

debt obligations of those borrowers could be considered to be issued "in connection with the same transaction", but it would not make sense to require that they be aggregated for purposes of applying the OID rules. Under section 163(e), the deductions allowed to each borrower would correspond to the amounts includible in income with respect to the obligations of that borrower. However, if that rule were followed and obligations of different borrowers were aggregated, one borrower's deductions would be affected by the terms of a second borrower's loan even though the terms of that second borrower's loan have no economic effect on the first borrower's payment obligations.<sup>56</sup>

(ii) The exception in section 1.1275-2(d)(2)(i) should be clarified and expanded. The exception applies to "[e]ach debt instrument held by the taxpayer [if it] is part of a series that is separately traded on an established securities market." It is not clear what the reference to "held by the taxpayer" accomplishes. Presumably, it was not intended that a debt obligation could be considered to have different amounts of OID at the same time in the hands of different taxpayers. In addition, as the exception is now written, it is uncertain whether the trading market for a debt instrument must exist at the time of issuance of the instrument or may develop at a later time. Presumably, it should exist within some period of time shortly after

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<sup>56</sup> Possibly different considerations would apply to blocks of stripped bonds or coupons subject to section 1286 because there would be no general correspondence between the holder's income and the deductions allowed to the issuers of the whole bonds.

issuance; otherwise, the issuer could not take deductions on a consistent basis over the life of the debt. Cf. section 1.1273-2(c)(1) (property is treated as traded if it is traded on an established securities market on or within ten trading days after the date it is issued).

Since the exception applies only to securities that are traded on an established securities market, section 1.1272-2(d)(1) could be read to require aggregation of two or more privately placed obligations that are sold to unrelated investors. Since the price paid for each obligation by an unrelated purchaser dealing at arm's length would establish the price as effectively as a public market, the exception should be expanded to cover that case.

A third case that should be excepted from the aggregation rule is where the proceeds of serial obligations having separate issue prices are lent by the issuer to a second borrower on terms that reflect the terms of the serial obligations. For example, suppose that a partnership wishes to issue serial obligations and does so through a corporate subsidiary in order to create corporate obligations that may be more favorably treated than partnership obligations under applicable legal investment laws. The subsidiary advances the proceeds of the borrowing to the partnership in exchange for notes that generally match the terms of the corporation's serial obligations. If the corporation is forced to aggregate the partnership's notes but must treat separately the different serial obligations that it

issues, it will experience a mismatching of income and deductions. Since an appropriate price for the partnership's notes can be determined by reference to the price paid for the corporation's obligations, there could be no abuse in extending the exception in (d)(2) to this case. Perhaps the exception could be modelled after section 1.482-2(ii) (arm's length interest rate for a loan of the proceeds of a borrowing determined by reference to the cost of the borrowing to the lender).<sup>57</sup>

More generally, what is wrong with the rule in the section 1232 regulation that allows different issue prices to be used for different serial obligations issued at the same time if independent issue prices can be established? Perhaps that rule could be continued but limited to cases where debt is issued in exchange for cash or other traded property, on the ground that where section 1274 applies, interest rates are generally tested by reference to the applicable Federal rate.

(iii) The exception in paragraph (d)(2)(ii) applies if each debt instrument calls for interest at "the lowest rate (or fixed multiple thereof)" that constitutes adequate stated interest. Is it necessary that this rule be so restrictive? For example, why should it not be possible to state rates of interest as a fixed number of basis points above the applicable Federal rate?

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<sup>57</sup> The exception should not require that the loan of proceeds of a borrowing precisely match the terms of the borrowing but instead allow independent issue prices to be established by reference to the terms of the related borrowing. When the "conduit" and the ultimate borrower are unrelated, they should have some freedom to set the terms of the loan between them.

Compare the definition of an objective interest index in section 1.1275-5(b), discussed below in part III.9.

(iv) Paragraph (d)(3) provides different effective dates for "installment obligations" and "serial debt instruments." Presumably, if obligations are both serial obligations and installment obligations (e.g., where different series of installment obligations are issued together), then the effective date rule for installment obligations would apply in determining whether each installment obligation of a particular final maturity would be treated as a group of separate obligations or as a single obligation, and the effective date rule for serial obligations would determine whether the different series of installment obligations would be treated as a single obligation. The cross reference to the regulations under section 1232 in the last sentence of paragraph (d)(3) should omit the final "(e)".

7. Information Reporting/Legending Requirements.

A. Description.

In the case of a publicly offered debt instrument issued with OID that is not excepted from the accrual rules of section 1272 under section 1272(a)(2), section 1.1275-3(a) requires that the issuer set forth on the face of the instrument:

- (i) the amount of OID,
- (ii) the issue date,

- (iii) the yield to maturity, and
- (iv) where there is a "short accrual period" (generally a short period until the first interest payment date), the method used to determine the yield for that period and the amount of OID allocable to that period.

In the event that it is not possible to print the required information on the debt instrument by the issue date, the issuer is required to deliver to the holder of the instrument a sticker containing the required information within ten days of the issue date.

A debt instrument that is not publicly offered is subject to the same general rule but the requirement to set forth information on the face of the instrument applies only upon a disposition of the instrument by the first holder and only if that disposition occurs after May 8, 1986.

In addition to the leg ending requirement, section 1.1275-3(b) requires that the issuer report to the IRS on Form 8281 certain information regarding publicly offered debt instruments issued with OID. This information includes the same items that must be set forth on the instrument (excluding, curiously enough, the yield to maturity) and certain other information. The information reporting requirement does not apply to obligations described in section 1272(a)(2), certificates of deposit and, unless otherwise required by the IRS pursuant to a revenue procedure, stripped bonds and stripped coupons (hereinafter, "stripped bonds"). Some of

the information reported on Form 8281 is published periodically in IRS Publication 1212.

Issuers failing to comply with the leg ending or information reporting requirements may be subject to penalties under section 6706.

The purpose of the leg ending and information reporting requirements is to make available to debtholders information required in calculating accruals of OID that might otherwise not be known. For example, the issue date and issue price of a debt instrument often cannot be determined from its terms and therefore are not likely to be known by holders other than original purchasers. Nonetheless, that information is necessary for the proper calculation of accruals of OID.

B. Comments.

We have a number of comments on section 1.1275-3, directed primarily at the leg ending requirement. Our principal comment is that we believe that the leg ending requirement should be eliminated with respect to publicly offered debt instruments. The requirement is burdensome but perhaps more importantly not likely to be of much use.<sup>58</sup> Most certificates evidencing publicly offered debt

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<sup>58</sup> The requirement may be burdensome because of the need to delay the printing of debt instruments until the required information is available and the possibility that reprinting will be required if any errors are made (which is not unlikely, given the complexity of the OID rules and the tight time schedule that often surrounds public offerings). The sticker alternative is not very palatable if it requires delivery of a sticker to many holders.

securities are held by depositaries or nominees, and not with tax records of the holders; We doubt that taxpayers would consult the fine print on the debt securities that they own if it were inconvenient to do, especially if the text of all debt instruments that they own must be consulted to determine whether particular instruments do or do not have OID. Moreover, there is a clear trend toward the elimination of physical securities in favor of securities held in book entry form. Even if the depositary for a book entry system through which a particular debt instrument was held had a piece of paper evidencing the security that was stamped with an OID legend, the beneficial owners of the security would not have access to that information unless some kind of additional reporting obligation was imposed on the depositary.

As an alternative to the leg ending requirement, we recommend that exclusive reliance be placed on Publication 1212 and information reporting under section 6049.<sup>59</sup> While some time would lapse between the date of issue of a debt instrument and the inclusion of information with respect to that instrument in Publication 1212, the information would not ordinarily be needed earlier than the date of filing of income tax returns for the year in which the instrument is issued, so that some delay should be acceptable. While individual taxpayers may not have ready access to Publication 1212, they are likely to receive Form 1099s reporting OID

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<sup>59</sup> We recommend that the information reported to the IRS and included in Publication 1212 be expanded to include the yield to maturity.

income. Furthermore, individual taxpayers are the group least likely to parse the text of physical securities searching for an OID legend. Because information reporting would not apply to most privately placed securities and the requirement is less burdensome for them, we would continue the leg ending requirement for privately placed securities.<sup>60</sup>

If our recommendation is not adopted, then we have some additional comments on the leg ending requirement. First, how will the requirement be applied to book entry securities? We expect that pending clarification the requirement will be met as a practical matter by stamping the legend on one physical security that will be held by the manager of the system.

The requirement to legend a debt instrument that is not publicly offered does not apply until the instrument is disposed of by the first holder.<sup>61</sup> Presumably, the reason for this leniency is that the first holder would know the issue date and issue price of the instrument (which would be the date and price of purchase by that holder). However, since the requirement is imposed on the issuer and the physical security is in the possession of the holder, it is not clear how the leg

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<sup>60</sup> No information reporting is required for privately placed securities under section 1.1275-3(b) and most holders of those securities would be described in section 6049(b)(4) and therefore not receive Form 1099s.

<sup>61</sup> If an investment bank purchases a privately placed debt instrument as principal and immediately resells it, would it be considered the first holder? Possibly so, since there is no exception for underwriters or other intermediaries.

ending requirement would be met by the issuer if the legend were not applied from the start. Because of this concern, we recommend that the leg ending requirement not be applied to debt instruments issued on or before May 8, 1986 merely because they are disposed of by the first holder after that date.<sup>62</sup>

In cases where it is not possible to legend a debt instrument by the issue date, the issuer is required to deliver to the holder of the debt instrument a sticker containing the required information within ten days of the issue date. Although not expressly stated, presumably any new physical securities that are issued thereafter (e.g., in connection with a transfer to a new holder or to replace a lost security) must also include the OID legend or have the sticker attached. Although the issuer

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<sup>62</sup> While an issuer or its agent would have access to a physical security upon its transfer to a new holder if the security is held in registered form and the transferee becomes the new registered holder, privately placed securities are not required to be held in registered form in the sense that transfers must be recorded with a registrar to be effective against the issuer. See section 163(f)(2)(A)(ii).

must deliver the sticker to the holder, there is no requirement, and indeed there could not be as a practical matter, that the holder attach the sticker to the debt instrument. What steps is the issuer required to take to "deliver" the sticker? We assume that mailing within the ten-day period to the address of registered holders would be acceptable and this should be stated.

The-ten-day period during which a sticker must be delivered should be extended. A debt instrument is considered to be traded on an established securities market within the meaning of section 1273(b)(3) if it is so traded within ten trading days of the issue date. At a minimum, the deadline for delivering stickers should extend several days beyond the end of this ten trading day period. We question whether the leg ending requirement should apply to Eurobonds that are sold and held in bearer form in accordance with section 163(f)(2)(B). Those obligations are permitted to be sold in bearer form because they are targeted to persons who are not U.S. taxpayer.<sup>63</sup>

Section 1275(c)(2), which imposes the requirement of filing OID information returns with the IRS, states that any person who makes a public offering of stripped bonds shall be treated, for purposes of the filing requirement, as the issuer of a publicly offered debt instrument having OID. There is no comparable

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<sup>63</sup> Indeed, an OID legend might prove to be confusing when paired with the "TEFRA legend" required by section 163(f)(2)(B)(ii)(II), which threatens sanctions for holders that are U.S. taxpayers.

provision in section 1275(c)(1) relating to the OID legend. We believe that the current exemption from the OID reporting rules for stripped bonds should be made permanent and that it should be made explicit in the regulations that the leg ending requirement does not apply to such securities. OID on a stripped bond is accrued based on each purchaser's date of purchase and yield to maturity; thus, information relating to the original offering date or offering price would be useless and potentially misleading.<sup>64</sup>

It is not clear how the leg ending requirement is to be applied to pools of mortgages or other loans that are first privately placed with lenders and then grouped and transferred to a grantor trust in exchange for pass-through certificates that are sold to investors. Under general tax principles, the pass-through certificates are not considered to be debt instruments of the trust; rather they merely evidence an ownership interest in the underlying loans.<sup>65</sup> Therefore, if a leg ending requirement applies to these mortgage pools, it

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<sup>64</sup> Each purchaser of a stripped bond is in the same position as the first purchaser of a privately placed debt instrument in that the price paid by the purchaser determines the issue price; in neither case is leg ending needed.

<sup>65</sup> Section 1.6049-5(a)(6) effectively treats mortgage and other pass-through certificates as debt instruments of the trust for purposes of information reporting under section 6049. However, that rule was adopted in a situation where there was a clear gap in information reporting. (Section 6049 did not apply to the underlying loans because, in most instances, these were obligations of individuals (see section 6049(b)(2)(A)).) Also an explicit regulation was thought to be necessary to impose the information reporting requirement on pass-through trusts.

would apply to the issuers of the underlying loans. Indeed, because there is no exemption from the leg ending requirement for obligations of individuals, individuals who borrow to buy homes or automobiles would be required, under the Proposed Regulations, to legend their debt instruments at the time when those instruments are transferred by the first holder if the debt instruments have OID. As discussed in part III.14. below, there are many examples of typical consumer loans that could be considered to have OID under the Proposed Regulations.

We doubt that the drafters of the leg ending rule intended to require individual consumers to legend debt instruments. On the other hand, we do not believe that it would be practical to require leg ending of pass-through certificates (even assuming that they could be viewed as debt instruments for this purpose) to show information with respect to each of hundreds or even thousands of underlying loans. The only practical solution to this problem that we can see is, first, the adoption of a more realistic de minimis rule (as discussed in part III.4.A. above) that would eliminate OID with respect to most consumer loans, and, second, for those few consumer loans that would still have OID, imposition of a leg ending and/or section 1275 information reporting requirement that permits information to be supplied in a generalized form for a typical loan, or a loan having the largest amount of OID,

rather than loan by loan.<sup>66</sup>

In view of the strong argument supporting the view that pass-through certificates are not debt instruments for purposes of the leg ending or section 1275 information reporting requirements, if any such requirements are extended to pass-through securities in future regulations, the rules should be prospective only and should provide for a substantial delay in effective dates after the date of announcement to take account of the lag between the date of origination of loans and the creation of pass-through certificates, and the change in computer and administrative systems necessary to compile the required information.

The information that must be set forth on a debt instrument includes its yield to maturity. What number should be used in the case of an obligation that provides for interest at a variable rate or contingent payments? One likely choice, in the case of a variable rate instrument subject to section 1.1275-5, is the hypothetical yield described in section 1.1275-5(d)(3)(ii).

Finally, section 1.1275-3(b) provides that, in the case of any publicly offered debt instruments issued

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<sup>66</sup> Another possible approach would be a statutory amendment that would permit the sponsor of a pool of diversified loans to elect to calculate OID on pass-through certificates issued by the pool by reference to the issue price of those certificates (as contrasted with the issue price of the underlying loans). Such an election would be binding on all holders of the certificates.

after August 16, 1984 that have original issue discount, the issuer is to make an information return on Form 8281. The term "issuer" is defined for this purpose as including not only domestic issuers but also any foreign issuer that is otherwise subject to United States income tax law, unless the issue in question is neither listed on an established securities market (as defined in section 1.453-3(d)(4)) in the United States nor offered for sale or resale in the United States in connection with its original issuance. The final regulations should clarify when a foreign issuer is considered to be "subject to United States income tax law." Presumably, a foreign issuer would be subject to such law if it was required to file a tax return to report a tax on net income from a U.S. trade or business but not be subject to such law if the only U.S. taxes imposed in respect of income of the issuer were withholding taxes on U.S. source investment income.

8. Contingent Payment Obligations.

A. Introduction.

Section 1275(d) authorizes the issuance of regulations modifying the general OID rules of sections 1271 through 1275 and 163(e) as they relate to contingent payments "to the extent appropriate to carry out the purposes" of those rules. Section 1.1275-4 of the Proposed Regulations responds to this challenge and sets forth rules governing the treatment of contingent payment obligations, including both obligations subject to

section 1274 and obligations that are issued for cash or publicly-traded securities.

Contingent payments pose a particularly vexing problem in applying the OID rules. The principal function of the OID rules is to require interest to be reported as it accrues based on the yield to maturity of a debt instrument, without regard to the timing of payments. However, this requirement presupposes (i) that accrued interest will eventually be paid and (ii) that the yield of the debt instrument can be calculated as of the issue date, giving effect to the timing and amount of future payments. Where future payments are contingent, neither assumption may hold true.

Part B below summarizes section 1.1275-4. Part C then discusses technical problems arising under the proposed contingent payment rules and suggests alternative approaches. Finally, part D discusses problems that arise in applying the Proposed Regulations to contingent stock payouts in reorganizations.

B. Summary of Section 1.1275-4.

(a) Definition of Contingent Payments.

Section 1.1275-4(b) defines a contingent payment only by exclusion. Specific exclusions are provided for: (i) insolvency or default contingencies, (ii) fixed or minimum payments of principal uncertain as to the time of payment but bearing fixed or variable-rate interest on the outstanding principal balance, and (iii) variable

payments of interest based on current values of an objective interest index. Section 1.1275-4(b) gives the IRS the discretion to disregard "remote and incidental contingencies". However, issuers and holders of debt obligations are bound to the form of the instrument and may not treat as non contingent any amount whose payment is subject to a "stated contingency".

(b) Instruments Subject to Section 1274.

Under section 1.1275-4(c) ("paragraph (c)"), a contingent payment obligation that is subject to section 1274 is separated into its contingent and non contingent components. The non contingent payments under the overall debt instrument are tested separately for adequate stated interest under section 1274. Contingent payments are generally ignored until they become fixed.<sup>67</sup> Once a contingent payment becomes fixed, it is treated as a principal payment to the extent of its present value as of the issue date of the overall debt instrument, except that the total amount of contingent payments treated as principal, when added to the sum of non contingent principal payments due under the debt instrument, cannot

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<sup>67</sup> However, under section 1.1274-3(d)(Z)(ii), an instrument that provides for contingent interest will be considered to have adequate stated interest if it provides for interest of at least 80% of the test rate disregarding the contingent interest, it is reasonable to expect that the contingent interest will raise the total yield of the instrument to 100% of the test rate, and the contingent interest is conditioned on profits, sales, rents, production, or royalties from the property acquired for the debt instrument. There is only one example illustrating when an expectation that contingent interest will raise the yield to the test rate will be considered to be reasonable. Additional examples would be helpful.

exceed any "fixed or maximum stated principal amount". Such present value is calculated by discounting the amount of such payment from the date it becomes fixed to the issue date at the applicable Federal rate. Contingent payments in excess of the amount treated as principal are treated as interest.

Section 1.1275-4(d) ("paragraph (d)") provides special rules for the treatment of a debt instrument subject to section 1274 that provides for fixed or minimum payments at an uncertain time within a specified time period. In very general terms, such payments are treated as non contingent payments to the extent of the minimum amount that is due at the latest possible time under the terms of the instrument and otherwise are treated as contingent payments subject to rules similar to those in paragraph (c).

If the principal amount of a debt instrument increases because a contingent payment becomes fixed and is considered to consist partly of principal, the purchase price of the property acquired in exchange for the instrument is correspondingly increased.

(c) Instruments Issued for Cash or Publicly-Traded Property.

A contingent payment obligation issued for cash or publicly-traded property that provides for non contingent payments (whether designated as principal or interest) at least equal to its issue price is governed

by the rules of section 1.1275-4(e) ("paragraph (e)"). These rules provide that the non contingent payments are treated as a separate non contingent debt obligation (analyzed under the general rules of sections 1272 through 1275), with an issue price equal to the issue price of the overall debt instrument and a stated redemption price at maturity determined under section 1.1273-1(b)(1).<sup>68</sup> Paragraph (e) apparently contemplates that the separate non contingent debt instrument would be considered to be issued at a premium where interest on that obligation is qualified periodic interest and its stated principal amount is less than its issue price.<sup>69</sup> Contingent payments under the overall debt instrument are treated entirely as interest, includible in income by the holder and deductible by the issuer in the taxable year in which the contingent amount becomes fixed.

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<sup>68</sup> It appears that the reference should be to section 1.1273-1(b) and not just to paragraph (1) thereof.

<sup>69</sup> The Proposed Regulations do not state whether the holder of such an obligation must make an election under section 171 in order to amortize the premium as an offset against non contingent stated interest. There is a discontinuity between paragraph (e) and paragraph (f), arising from the fact that non contingent stated interest that is qualified periodic interest is recognized to be interest under paragraph (e), even though it may be offset through premium amortization, whereas non contingent stated interest is always treated as principal under paragraph (f). Thus, if a contingent payment bond issued for cash of \$1,000 provides for a non contingent principal payment of \$900 after 10 years and non contingent annual interest of \$10, then the bond would be subject to paragraph (e) and the annual interest payments would be recognized to be interest subject to possible offset through amortization of the \$100 premium. However, if the final principal payment were reduced by \$1 to \$899, paragraph (f) would apply and all interest on the bond would be converted to principal.

A contingent payment obligation that does not provide for non contingent payments at least equal to its issue price is subject to a different set of rules under section 1.1275-4(f) ("paragraph (f)"). According to these rules, all non contingent payments under the overall debt instrument, whether designated as principal or interest are treated as principal payments. Contingent payments, however, are separated into those made prior to maturity of the overall debt instrument and those made at maturity.

Under paragraph (f)(2), a contingent payment made prior to maturity is treated first as interest to the extent of the aggregate amount of "deemed accrued interest" on the overall debt instrument for the current accrual period and all prior periods that has not been allocated to prior contingent payments. The deemed accrued interest for any accrual period equals the product of the "adjusted issue price" of the debt instrument at the beginning of the accrual period and the applicable Federal rate (as determined by reference to the due date of the final payment called for under the debt instrument). The adjusted issue price of a debt instrument at the beginning of any accrual period is its original issue price, plus the amount of deemed accrued interest for all prior accrual periods, and less the amount of all payments (both contingent and non contingent) made in prior accrual periods. Contingent payments that are not allocable to deemed accrued interest are generally treated as principal payments. However, once the total amount of such payments that have

been characterized as principal equals the issue price of the overall debt instrument reduced by the sum of all past and future non contingent payments there under, then any additional contingent payments are treated entirely as interest.

Under paragraph (f)(3), the characterization of contingent payments made at maturity is reversed. Thus, contingent payments at maturity are treated first as principal payments to the extent of the instrument's outstanding principal balance. Contingent payments in excess of the outstanding principal balance are treated entirely as interest. If the final contingent payment under a debt instrument is less than its outstanding principal balance, then the debt instrument is treated as being retired for the amount of the contingent payment. Although paragraph (f) is not clear on this point, in this case, the holder probably would realize a capital loss, while the issuer probably would realize discharge of indebtedness income.

(d) Delayed Contingent Payments.

The Proposed Regulations provide special rules for a contingent payment that is due more than six months after the date on which it becomes fixed. Very generally, the deferred payment is treated as a separate bond that is issued on the date that the payment becomes fixed and matures on the date that the payment is due. The principal amount of the hypothetical bond is the amount of the payment, and its issue price is determined by discounting the hypothetical principal amount to the date

that the payment becomes fixed at the applicable Federal rate. An amount equal to this hypothetical issue price is treated as being paid on the date that the contingent payment becomes fixed and is characterized as interest or principal under the same rules that would apply to an actual cash payment.

(e) Reallocation of Interest to Prevent Abuse.

Section 1.1275-4(g) ("paragraph (g)") gives the IRS specific authority to reallocate interest in a manner consistent with the general rules of section 1.1272 if (i) contingent payments under a debt instrument are computed in a manner that can reasonably be expected to produce front loading or back loading of interest deductions and (ii) the principal purpose for such a payment scheme is the avoidance of federal income tax. In determining whether such a purpose exists with respect to a particular debt instrument, paragraph (g) directs the IRS to give considerable weight to the relative status of the issuer and the holder as taxpayers.

(f) Omitted Items.

The Proposed Regulations give no guidance as to the character of gain recognized upon sale of a contingent payment obligation or the treatment of a subsequent holder. They also do not include rules for obligations that are issued for cash or publicly-traded property and provide for payments that are contingent only as to the time of payment.

C. Comments.

(a) Definition of Contingent Payments.

Section 1.1275-4(b) provides exceptions from the contingent payment rules for insolvency or default contingencies and for variable-rate interest payments.<sup>70</sup> We agree that these exceptions are appropriate. However, we recommend that the definition of the types of contingent payments that fall within the regulation be clarified or changed in some other respects, as discussed below.

(i) Options. Section 1.1272-1(f)(4) specifically addresses obligations subject to put or call options and options to extend the term of debt instruments. A statement should be included in section 1.1275-4 to the effect that a debt obligation that is contingent because of the existence of an option subject to the put/call rule in section 1.1272-1(f)(4) will not for that reason be considered to provide for contingent payments.

An instrument that is contingent solely because it is convertible into stock of the issuer or of a corporation under common control with the issuer also should be excluded from the definition of a contingent

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<sup>70</sup> Section 1.1275-4(b)(1) states that "[a] payment shall not be considered a contingent payment merely because the amount of or liability for the payment may be impaired by insolvency or default." Because a default would, in the first instance, affect only the timing of payments, it would be desirable to insert in this sentence "or timing" after "amount" and to substitute "affected" for "impaired".

payment obligation. Such debt obligations should continue to be governed by present law. The treatment of debt instruments with conversion or exchange features is discussed below in part III.14.

(ii) Obligations with fixed payments denominated in foreign currencies. Obligations that are contingent solely because payments are expressed in foreign currency units should be dealt with under a special regime. The IRS has announced<sup>71</sup> that a debt instrument will not be subject to the contingent payment rules in the Proposed Regulations because the instruments provide for payments in or measured by foreign currency units and a permanent exception for such payments should be included in the final regulations. See part III.15. below.

(iii) Principal payments contingent only as to time. An exception has been provided in section 1.1275-4(b)(2) ("paragraph (b)(2)") for a debt instrument that calls for fixed or minimum principal payments that are uncertain as to the time of payment and that also calls for payments of interest on the unpaid principal balance at a fixed or variable rate (which, in a transaction subject to section 1274, constitutes adequate stated interest).<sup>72</sup> Such an exception may be justified in a case where the instrument has a constant yield, on the ground that the contingency could not then affect the

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<sup>71</sup> Announcement No. 86-92 (July 30, 1986).

<sup>72</sup> The reference to interest at a "variable rate" presumably means interest based on current values of an objective interest index within the meaning of section 1.1275-5(a). If so, the language should be clarified.

rate of accrual OID. Paragraph (b)(2) as written is not so limited, although the only illustration of the exception (Example (14) at section 1.1272-1(k)) involves a debt instrument that has a constant yield.

Paragraph (b)(2) states that OID accruals with respect to payments to which the paragraph applies will be determined under section 1.1272-1(c) (where interest is payable at a fixed rate) or sections 1.1272-1(f)(3)(ii) and 1.1275-5(d) (where interest is payable at a variable rate) and therefore not under the contingent payment rules.<sup>73</sup> It is not clear how OID accruals would be determined under these sections in a case where yield changes depending on when principal payments are made.

In the case of a debt instrument that has both principal and interest payments subject to paragraph (b)(2) and additional contingent payments, it is uncertain how income would be computed with respect to the contingent payments.<sup>74</sup> In particular, because the

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<sup>73</sup> The meaning of the reference to section 1.1272-1(f)(3)(ii) is obscure. This section states that the yield of a debt instrument that has an issue price equal to its stated principal amount and provides for interest at a fixed rate over its entire term compounded at periodic intervals of at least one year equals the stated interest rate.

<sup>74</sup> The last sentence of paragraph (b)(2) together with the reference to "minimum" payments of principal clearly implies that the presence of additional contingent payments will not prevent the paragraph from applying to the fixed or minimum principal and fixed or variable interest components of the instrument. Section 1.1272-1(f)(3)(iii) states that the yield of a debt instrument that provides for contingent payments generally will be determined by reference to only the non contingent payments. This would indicate that the additional contingent payments should be ignored in applying section 1272 to the payments to which paragraph (b)(2) applies.

payments to which paragraph (b)(2) applies would not be subject to the normal rules in paragraphs (e) and (f) governing non contingent payments on contingent payment obligations (as they would instead be subject to section 1.1272-1(c) or 1.1275-5(d)), it is not clear whether or how those rules would apply to the additional contingent payments.

Finally, the language of paragraph (b)(2) as now written leaves open the question whether the exception would apply to a fixed rate debt instrument that permits payments of principal and interest to be deferred and that bears only simple interest (i.e., interest is paid only with respect to principal and not deferred interest). Such an instrument calls for payments of interest on the unpaid principal balance which is all that paragraph (b)(2) literally requires.

Paragraph (b)(2) would be improved if it were limited to debt instruments that have constant yield.<sup>75</sup> However, if the practical consequence of applying paragraph (b)(2) to an instrument is that interest thereon is taxed as it accrues based on the instrument's constant yield, and further, if our proposed rule (discussed below) for payments that are contingent only as to time is adopted, then there would be little point in excluding the instrument from the contingent payment rules because the same OID accruals would be required

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<sup>75</sup> Note that even if yield were constant in the hands of an initial holder, some mechanism would be needed to deal with uncertainty in the timing of payments in the case of a subsequent holder who purchases the obligation at a price above or below its basis to the initial holder.

under those rules as under paragraph (b)(2). In these circumstances, we recommend that paragraph (b)(2) be dropped.

(iv) Standard for measuring uncertainty of payments. Further guidance is needed as to the degree of uncertainty that will cause a payment to be treated as contingent. The Proposed Regulations state only that the IRS can disregard remote and incidental contingencies and that tax-payer are bound to treat payments subject to stated contingencies as contingent.

Under the Proposed Regulations as currently drafted a determination that a payment is or remains contingent has the effect of deferring the recognition of interest income and deferring interest deductions. Presumably, then, the power of the IRS to disregard remote and incidental contingencies is intended to prevent the creation of OID securities that, in practical terms, are non contingent but that are made subject to contingencies with a view to preventing the accrual of OID by holders in circumstances where the issuer would not benefit from current interest deductions.<sup>76</sup> The reason for requiring taxpayers to treat payments subject to stated contingencies as contingent payments is, we suspect, to prevent holders from asserting that a payment is contingent at the same time that the issuer contends

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<sup>76</sup> One example of such an obligation might be a zero coupon bond that pays a stated amount at maturity subject to being reduced to an amount equal to the issue price if the average annual inflation rate over the life of the bond is less than 1%.

that it is not. Under the Proposed Regulations, issuers would be required to defer deductions for payments subject to a stated contingency even though the IRS could take the position that holders should be taxed as if the contingency did not exist. Issuers can presumably avoid this calamity by making sure that any stated contingencies are real.

It would be helpful if the Proposed Regulations set forth some general standard for determining the point at which uncertainties will be disregarded (so that a payment will be recognized to be non contingent or a previously contingent payment will be considered to be "fixed"). One possibility would be to rely on the "all events" test that generally applies in determining whether amounts are includible in income or are deductible (before application of section 461(h)) by an accrual basis taxpayer.<sup>77</sup> The "all events" test is familiar to both the IRS and taxpayers and has been interpreted and applied in a variety of cases and rulings.

Another possible standard that is more tailored to the context of, section 1.1275-4 would be to rely on market forces and to ignore contingencies that would not

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<sup>77</sup> See, e.g., Treas. Reg. § 14511(a): "Under an accrual method of accounting, income is includible in gross income when all events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." It is not clear whether this test differs from a requirement that the "amount" of a payment be "fixed".

significantly affect the pricing of a debt obligation (disregarding tax effects). Such a standard would most likely have to be limited to publicly offered debt instruments and also could be used only in determining whether payments are contingent or non contingent as of the issue date.

Even with the assistance of a general standard, it is inevitable that some difficulty will be encountered in practice in drawing the line between contingent and non contingent payments. For example, suppose that a zero coupon bond is issued that provides for a single payment at maturity equal to the issue price multiplied by the value of a broad based U.S. consumer price index ("CPI") at the maturity of the bond divided by the value of the CPI at the issue date. If the CPI increased prior to maturity, would the corresponding increases in the principal amount be considered to be fixed on the ground that the likelihood that they will be offset by subsequent decreases is highly remote? It is not clear that the answer to this question would always be "yes". On the other hand, if the answer is "no", taxpayers would effectively be permitted to elect in or out of current taxation of increases in the CPI by allowing, or not allowing, under the terms of the bond an offset of prior increases by subsequent decreases.<sup>78</sup>

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<sup>78</sup> The increases would probably not be considered to be fixed under an "all events" standard. See Utility Trader Mfg. Co. V. United States, 212 F. Supp. 772 (D.C S.D.Calif. 1962) (discount created by increases in the principal amount of "Registered Inflation Provision Notes" calculated by reference to a consumer price index could not be deducted currently by an accrual basis issuer since the increases could be

(footnote continued)

The practical difficulty of -determining whether or not a payment is contingent is, in our view, a strong argument for adopting the "comparable non contingent bond" approach for taxing contingent payment obligations described below. That approach attempts to minimize differences between the treatment of contingent and non contingent obligations so that less pressure is placed on the definition of a contingent payment.

(v) Stated contingencies. Section 1.1275-4(b)(1) provides that the parties to a transaction are bound by it form. Thus, neither party may treat any amount under a debt instrument whose payment is subject to a stated contingency as non contingent. We do not know what it means for a contingency to be "stated" and are concerned that this language will lead to senseless debates over drafting style that have little to do with its purpose, which is, presumably, to prevent the whipsawing of the government. If this approach is continued in the final regulations, examples should be added illustrating when a contingency is considered to be stated.

A better approach (or at least one more directly related to the problem of inconsistent tax positions) might be to require the issuer to treat a payment as contingent if the issuer (i) represents to holders that

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(footnote continued from previous page) eliminated by subsequent decreases). On the other hand, if the standard were one of materiality to investors, increases in the CPI would almost certainly be considered to be fixed as they occur; it is highly unlikely that investors would distinguish between two CPI indexed instruments that were identical except that one allowed an offset of decreases in the index against prior increases and the other did not.

the payment will be considered to be contingent for federal income tax purposes or that income will be computed on a basis which assumes that the payment is contingent, (ii) represents to holders that interest income will be reported under section 6049 on that assumption, or (iii) in fact reports interest income under section 6049 on that assumption.

(b) Obligations Subject to Section 1274.

Section 1274 requires that a debt instrument be treated as bearing interest at a rate at least equal to the applicable Federal rate, but does not generally prevent taxpayers from providing for a higher rate of stated interest. However, section 1.1274-1(d) provides that if stated interest is excessive (i.e., the parties are attempting to convert payments that would otherwise be included in the basis of property into interest), then the IRS may re characterize a portion of the stated interest as additional purchase price.

An obligation subject to section 1274 poses a special problem in applying the contingent payment rules because there are two unknowns: the timing and/or amount of the contingent payments and the issue price. The Proposed Regulations generally address the problem by disregarding contingent payments until they become fixed and then calculating the issue price attributable to those payments based on the applicable Federal rate. Increases in the issue price of an obligation attributable to contingent payments are taken into

account as an increase in the sales price and basis of the property acquired in exchange for the obligation. While this rule ensures that the interest component of a debt instrument will never be less than interest calculated at the applicable Federal rate, if it applied to all contingent payments without limitation, then the interest component of a contingent debt instrument could never exceed interest computed at the applicable Federal rate, contrary to the general rule of section 1274 which allows taxpayers to provide interest at a higher rate which is no excessive. The Proposed Regulations allow the general rule to operate by limiting the issue price (the principal component of the debt instrument) to the fixed or maximum stated principal amount of the instrument.

The effect of these rules may be to allow taxpayers considerable flexibility in determining the mix of principal and interest. If it is desired to maximize the seller's noninterest income and the buyer's basis in the property at the cost of interest deductions to the buyer, then the fixed or maximum stated principal amount could be set at a high number. On the other hand, if the parties wished to maximize interest income and expense, a low principal amount could be chosen.

We do not have an alternative approach to recommend that is consistent with section 1274 and further limits the possibility of abuse. However, we do suggest that the regulations acknowledge the problem. For example, the regulations should make it clear that amounts characterized as interest under section 1.1275-4

are not immune from scrutiny under the excessive interest rule in section 1.1274-1(d). In addition, while increasing the basis of purchased property by the present value of contingent payments makes sense if the contingency is tied to the performance of the property, the business motivation for using a contingency unrelated to such performance may not be so obvious. Perhaps transactions where the latter type of contingency is present should be subject to special scrutiny in applying the excessive interest rule or be classified as potentially abusive under section 1.1274-4(g).

The last sentence of paragraph (c)(3)(i) reads as follows: "Once the total of the non contingent principal payments due under the debt instrument and the portion of the contingent payments treated as principal exceeds the amount described in the preceding sentence, any additional contingent payments shall be treated entirely as interest." It should be stated more clearly that the amount of the "non contingent principal payments" is determined after the application of section 1274 (i.e., is net of any amount treated as interest under section 1274). See paragraph (c)(4), Example (1).

Paragraph (d)(2) provides that, in the case of certain obligations that provide for fixed or minimum payments within a specified time period, for purposes of determining the buyer's basis in the property purchased and the allocation of interest to the proper accrual periods, all future payments shall be presumed to be made at the latest possible date and in the smallest possible

amount. Paragraph (d)(2) states that this rule "shall not apply for purposes of determining the recovery of basis of the seller as a result of the sale or exchange of the property." This sentence leaves obscure the proper treatment of the seller and is somewhat curious in view of the suggestion in paragraph (c) that there would be parallel treatment between the buyer and the seller (see paragraph (c)(4), Example (1)(iii)). More generally, the relationship between the contingent payment rules in the Proposed Regulations and the rules for contingent payment obligations issued in an installment sale, as set out in the regulations at section 15a.453-1(c), is unclear.

Paragraph (d) appears to assume that the latest date by which a minimum or fixed amount will be paid will not change. Thus, calculations are made under paragraph (d)(2)(i) assuming that fixed or minimum amounts will be paid at the latest date possible, and under paragraph (d)(2)(ii) when a fixed or minimum payment "is made", but no account is taken of the intermediate case where the final due date for a fixed or minimum payment is advanced, but the payment is not yet made. As paragraph (d)(2) is now written, it is possible that the increase in the present value of an unpaid amount that results from an acceleration in its final due date would be treated as OID for the period in which the acceleration occurs (under paragraph (d)(2)(iv)) and not as an increase in basis. It makes no sense to apply different principles to an actual prepayment of a fixed or minimum amount an acceleration in its due date. Therefore, we recommend that paragraph (d)(2)(ii)(B) be expanded to

apply to the case where the due date of an unpaid amount is accelerated.

(c) Obligations Issued for Cash or Traded Property.

(i) Problems with proposed rules. In the case of debt instruments issued for cash or publicly traded property, paragraphs (e) and (f) distinguish between those payments that are non contingent, and those that are contingent, as of the issue date. Non contingent payments are offset, dollar-for-dollar, against the issue price and to that extent are treated as principal (i.e., a nontaxable recovery of cost). In applying this rule, no account is taken of the timing of non contingent payments or their relationship, in terms of timing or amount, to contingent payments. Contingent payments are ignored until the period in which they become "fixed". In that period, either the amount of the contingent payment or, if the payment is due more than six months in the future, its present value is treated (i) entirely as interest if the aggregate amount of non contingent payments equals or exceeds the issue price or (ii) if the issue price exceeds the aggregate amount of non contingent payments, as interest or principal, with the principal component being limited in the aggregate for all contingent payments to the amount of such excess. Except for the fact that the portion of the contingent payments that is treated as principal is limited to the excess of the issue price over the aggregate amount of non contingent payments, no account is taken of the amount or timing of

non contingent payments in characterizing contingent payments.

While we have no desire to encourage complexity for its own sake, we believe that paragraphs (e) and (f) are overly simplistic. In particular, greater weight should be given to the timing of contingent and non contingent payments and to the relationship between the two types of payments in terms of timing and amount. The inadequacy of the proposed rules may be illustrated by the following examples:

Example (1). A bond is issued on September 1, 1987 for \$1,000 in cash. The bond provides for an unconditional principal payment of \$1,000 on December 31, 1992 and interest that is payable in arrears on January 2, 1988 (the "determination date") and on each subsequent December 31 through and including the maturity date. The rate of interest is fixed on the determination date and equals a predetermined number of basis points over 105% of the average market yield of five-year U.S. Treasury bonds on that date. Assume that the rate of interest fixed on the determination date is 12%, with the result that interest payments are made in the amount of \$40 on the determination date and \$120 on each subsequent interest payment date. Assume further that the applicable Federal rate, with annual compounding, is 10%. Under paragraph (e), the issuer of the bond would be allowed an interest deduction, and the holder would report interest income, for 1988 (assuming both are

calendar year taxpayers) in the amount of \$540.38, which is the sum of (i) \$40, (ii) \$454.89, the present value on the determination date of five annual payments of \$120 calculated using a discount rate of 10% and (iii) the portion of the discount of \$145.11 (\$600 minus \$454.89) relating to those five payments that accrues in 1988. The balance of that discount would be reported as it accrues in the four following years. In summary, interest on the bond would be reported as follows under the Proposed Regulations:

<u>Year</u>	<u>Interest Amount</u>
1988	\$540.38
1989	38.04
1990	29.84
1991	20.83
1992	<u>10.91</u>
	\$640.00

By contrast with the foregoing results, the intuitively correct approach would be to spread interest evenly over the entire term of the bond (or perhaps over the portion of that term beginning with the determination date).

Example (2). A bond is issued for \$1,000 in cash that provides for five non contingent annual interest payments of \$120 and a final payment after five years equal to \$1,000 plus or minus an adjustment based on the change (if any) in the value of a specified U.S. Treasury debt instrument between the issue date and maturity date of the bond. This adjustment would

reduce the final principal payment to a fixed floor of \$400 if interest rates rose above 20%. Assume that the normal five year borrowing rate for the issuer is 12%. In other words, the possibility that the principal amount of the bond will increase above \$1,000 is considered to offset the possibility that it will decrease below that amount so that the annual coupon rate of interest on the bond is the same as would be required if the principal amount were fixed at \$1,000. If the final principal payment turned out to be \$1,000, then the amounts of interest that would be reported on the bond under the Proposed Regulations would be as follows:

<u>Bond Year</u>	<u>Interest Amount</u>
1	\$0
2	0
3	0
4	0
5	<u>\$600</u>
	\$600

Given the \$1,000 valuation placed on the contingent principal payment at the time of issuance of the bond, a more appropriate result would be to treat the annual interest payments entirely as interest rather than entirely as principal.

Example (3). A bond is issued for \$1,140 in cash that provides for an unconditional principal payment of \$1,000 at the end of five years. Interest on the bond is payable annually at the rate of 14% for the first year and at a rate for each subsequent year of 20% minus the value of LIBOR at the beginning of such

year.<sup>79</sup> Assuming that LIBOR remains constant at 6% over the life of the bond, the amounts of interest that would be reported under the Proposed Regulations would be as follows:

<u>Bond Year</u>	<u>Interest Amount</u>
1	\$0
2	140
3	140
4	140
5	140
	\$560

In effect, the \$140 premium would be recovered entirely in the first year because of the non contingent interest payment that is made in that year. The intuitively correct result would be to amortize the premium over the life of the bond.

Example (4). A bond is issued for \$800 that provides for an unconditional principal payment of \$1,000 at the end of ten years and interest payable

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It is assumed that the variable interest on the bond would not be Qualified Indexed Interest that would be accounted for under section 1.1275-5. One question raised by the example is the relationship between the contingent payment rules and the rules for amortizing bond premium found in section 171. Paragraph (f) clearly contemplates a situation where the issue price of a debt instrument exceeds the aggregate amount of non contingent payments there under, and would therefore appear to extend to the bond in the example unless section 171 was thought to be preemptive. It is important to clarify the priority of application of the contingent payment rules and section 171 for two reasons. First, the timing of reporting of income may not be the same under the two regimes. Second, the contingent payment rules are mandatory, but section 171 is elective.

at the end of each year at a rate of 12% minus the value of LIBOR at the time of the payment. Under paragraph (e), the contingent interest would be treated as interest and reported in the period in which it becomes fixed, which is a proper result.<sup>80</sup> However, for purposes of accruing the \$200 discount, the contingent interest payments would be ignored. Thus, the bond would be treated as if it provided for a single payment of principal of \$1,000 at the end of ten years and no stated interest. Because the bond would have a very low yield (2.24% assuming semiannual compounding), the \$200 discount would be amortized under a virtually straight-line method, as shown in Appendix A, column (1). It would seem more appropriate to accrue the discount in a manner that reflects the compounding of interest at a market rate rather than an artificially low rate.

(ii) Alternative approaches. As these examples suggest, paragraphs (e) and (f) can produce highly questionable results as applied to some types of contingent payment obligations. At least three alternative approaches can be imagined. These approaches will be referred to herein as the "comparable non contingent bond approach", the "investment account

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<sup>80</sup> Section 1.1275-4(e)(3)(i) indicates that the holder of the bond would include a contingent interest payment in income in its taxable year in which the payment becomes fixed. Suppose that the bond in Example (4) is purchased by an investor two weeks prior to the date when an annual interest payment is fixed. The Proposed Regulations could be read to require that the full annual payment be included in the income of the new investor, although that would clearly be an improper result. Instead the interest should be allocated to some extent to the prior holders of the bond during the year.

approach" and the "dual security approach". We believe that the comparable non contingent bond approach should be adopted, or at least used as the guiding principle in drafting revised contingent payment rules. If that is not done, the investment account approach would be our second choice. It is easier to apply than the comparable non contingent bond approach but more likely to produce distortions of income. The dual security approach is discussed for the sake of completeness and we do not support its adoption.

The comparable non contingent bond approach and the investment account approach are similar in that each attempts to determine the interest on a debt instrument properly attributable to a period by applying an assumed market rate of interest ("assumed rate") to the total amount of capital invested in the instrument (including accrued and unpaid interest) at the beginning of the period. The two approaches differ only in the adjustments that are made to take account of the "fixing" of contingent payments in cases where those payments become fixed in amounts that cause the actual yield of a debt instrument to differ from the assumed rate.

(a) Comparable non contingent bond approach.

Before an obligation can become subject to the contingent payment rules, it must first be recognized to be a debt obligation for federal income tax purposes. Accordingly, a contingent payment obligation can be expected to provide for some non contingent payments and also to bear at least some resemblance to a conventional debt

instrument.<sup>81</sup> The first of the three approaches, the comparable non contingent bond approach, attempts to identify the wholly non contingent bond that most closely resembles the contingent bond. The interest (including accrued OID and adjusted for any premium amortization) that is reported in any period by the issuer and holders of the contingent bond is generally calculated as the interest that would have been reported by them in that period under an accrual method if they had issued or held the comparable non contingent bond rather than the contingent bond. Adjustments are made whenever a contingent interest or principal payment on the contingent bond becomes fixed, but only to reflect the difference, if any, between the actual amount of the (now fixed) contingent payment and the corresponding assumed interest or principal payment on the comparable non contingent bond.

To be more precise, the following steps would be followed in applying the comparable non contingent bond approach to a contingent bond:

- (1) Identify the contingent and non contingent payments on the contingent bond. The comparable non contingent bond would have the same non contingent payments as the contingent bond

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<sup>81</sup> Section 1.385-5, as adopted by T.D. 7747, 1981-1 C.B. 140, and subsequently withdrawn, provided that a "hybrid instrument" would be classified as stock unless, in general, at least half of its initial fair market value was attributable to non contingent payment rights.

(2) By definition, the comparable non contingent bond can have only non contingent payments. Thus, to create that bond, a non contingent payment must be substituted for each contingent payment on the contingent bond. This should be done in such a manner that (i) the yield to maturity of the comparable non contingent bond equals the assumed rate and (ii) the relative amounts and timing of the non contingent payments that are substituted for the contingent payments track the expected relative amounts and timing of those contingent payments, determined as of the issue date. For example, if the contingent bond provided for non contingent principal payable at maturity and contingent interest that was payable annually based on the same formula for each year, then the non contingent interest payments substituted for the contingent interest payments would be a series of equal payments that were made on the same dates as the contingent interest payments. On the other hand, if no interest payments were to be made on the contingent bond in the first two years, but interest was payable annually beginning in the third year based on the same formula for each year, the comparable non contingent interest payments would be zero for the first two years and an equal annual amount thereafter.

(3) The assumed rate would represent a market rate of interest for the comparable non contingent bond as of the issue date (or earlier contract date). Ideally, it would equal the borrower's normal

borrowing rate. However, for administrative reasons, it would probably be necessary to substitute the applicable Federal rate, or possibly some multiple thereof (e.g., 110%). The assumed rate would, of course, be properly adjusted for the length of any period to which it was applied. The assumed rate must also be a rate that could be achieved under the terms of the contingent bond depending on how contingencies are resolved. Thus, if the actual yield to maturity of the contingent bond, determined assuming that all contingencies were resolved so as to minimize such yield, exceeded the assumed rate that would otherwise apply, the assumed rate would equal such higher yield. Similarly, if the actual yield to maturity of the contingent bond, determined assuming that all contingencies were resolved so as to maximize such yield, was less than the assumed rate that would otherwise apply, the assumed rate would equal such lower yield.

(4) Except for the adjustments described in step  
(5) below, the issuer and holders of the contingent bond would report income in each taxable year as if they actually held the comparable non contingent bond rather than the contingent bond and as if all interest on the comparable non contingent bond was OID (regardless of whether interest might otherwise be qualified periodic interest). In other words, interest would be reported as it accrues (whether or not the accrued interest has been

received in cash) under a constant yield method based on a yield equal to the assumed rate.

(6) In the event that a contingent payment becomes fixed in the same period in which it is payable,<sup>82</sup> then the difference between (i) the actual amount of the (now fixed) contingent payment and (ii) the amount of the payment on the comparable non contingent bond that was substituted for such contingent payment would be taken into account, as additional ordinary income or an ordinary loss, in that period.<sup>83</sup> In the event that a contingent payment becomes fixed in a period before it is payable, then in the period in which the payment becomes fixed, a new comparable non contingent bond would be considered to be exchanged for the old one. The new bond would be identical to the old one except that the actual amount of the now fixed contingent payment would replace the estimated non contingent amount that was originally used.<sup>84</sup>

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<sup>82</sup> We would recommend that income be computed with reference to the accrual periods that would apply to the comparable non contingent bond.

<sup>83</sup> It might generally be appropriate to treat such a loss as an interest expense so that it could be used, in the case of taxpayers subject to investment interest limitations, only to offset investment income (cf. section 643 of TRA 1986, which treats amortizable bond premium as interest expense). However, the loss should in all events be allowed to the extent of any investment income reported by the taxpayer with respect to the particular contingent bond in all prior years.

<sup>84</sup> If a put or call right ceases to be subject to a contingency that prevented the application of section 1.1272-1(f)(4), a new comparable bond having the same terms as the old but with non contingent put or call rights would be considered to be  
(footnote continued)

The income adjustments required because of the deemed exchange could be taken into account over the remaining term of the new bond, in the same manner as if the new bond were exchanged for the old one in a recapitalization exchange under section 354, or, alternatively, could be reflected in the period of the exchange by calculating the income for that period as (i) the present value as of the end of the period of all payments on the new bond, computed using the assumed rate as the discount rate, plus the amount of payments in that period minus (ii) the adjusted issue price of the old bond at the beginning of that period.<sup>85</sup> If such difference was negative, the ability to deduct the loss currently might be limited as discussed above in this step (5).

In order to make these rules more concrete, it may be helpful to apply them to the bonds in the four examples above. The bond in Example (1) provides for a non

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(footnote continued from previous page)  
substituted for the old bond and section 1.1272-1(f)(4) would be applied at the time of the deemed exchange to determine whether those rights would be considered to be exercised.

<sup>85</sup> We do not mean to suggest that taxpayers could choose between these methods. Rather, one or the other would be specified in the regulations. We would generally prefer the first of the two methods for fear that the alternate method could produce large variations in income from one period to another that may not reflect equally dramatic changes in the fair market value of the contingent bond. Section 672 of TRA 1986 effectively adopts the second method to take account of prepayments of certain mortgage backed securities. However, those prepayments are unlikely to be concentrated in a small number of periods so that, in the mortgage context, the risk of income bunching is small. If the second method is adopted, the aggregate amount of income for the period in which a contingent payment is fixed should be spread ratably over the period. Thus, income attributable to the fixing of the payment should not be allocated solely to the hapless taxpayer who happens to hold the contingent bond on the date on which the payment is fixed.

contingent principal payment of \$1,000 at maturity. Therefore, the comparable non contingent bond would provide for the same principal payment (step (1) above). The contingent bond also provides for interest at a constant (although contingent because not yet determined as of the issue date) rate, with payments of four months' worth of interest on the determination date (January 2, 1988) and a full year's interest on each following December 31 until December 31, 1992. Therefore, the comparable non contingent bond would provide for interest at a constant rate with corresponding payments of interest at that rate. In addition, because the comparable non contingent bond must by definition have a yield equal to the assumed rate, and the bond in Example (1) has an issue price and principal amount of \$1,000, that constant rate of interest would equal the assumed rate (step (2) above). In 1987 and (except for adjustments described in the next sentence required to take account of the fixing of the rate of interest on the determination date) in all subsequent years, the issuer and holders of the bond would report interest as it accrues at the assumed rate (step (4) above). On the determination date, the rate of interest on the bond will be determined and accordingly all of the contingent interest payments on the bond will become fixed. Consequently, on that date, a new comparable non contingent bond providing for interest at the actual rate so determined would be considered to be exchanged for the old comparable non contingent bond. If it happened that the actual rate of interest equalled the assumed rate, then the old and new bonds would be identical and the

amount of interest reported in all periods would be the same as if the contingency had never existed. On the other hand, if the rates are not the same, an adjustment would be made, either in 1988 or over the remaining term of the bond depending on which adjustment mechanism was used, to account for the difference between the rates (step (5) above).

Turning to Example (2), the comparable non contingent bond would provide for five annual interest payments of \$120 and a single final principal payment. The amount of the principal payment would be the amount that would cause the comparable non contingent bond to have a yield equal to the assumed rate. Thus, if the assumed rate were 12%, the principal amount of the comparable non contingent bond would be \$1,000, interest of \$120 would accrue in each year prior to maturity, and income in the final year would equal \$120 plus or minus the difference between the actual principal payment and \$1,000. On the other hand, if the assumed rate were, for example, 8% or 14%, then the comparable non contingent bond would have a principal amount of \$765.34 or \$1,132.20, respectively. Interest on that bond would accrue based on the assumed rate. Thus, in effect, the stated interest would be reported as it accrued, and the premium of \$234.66 (\$1,000 less \$765.34), or discount of \$132.20, would be amortized under a constant yield method based on a yield of 8% or 14%, respectively. Income would be increased or decreased in the final year to account for the difference between the assumed and actual principal amounts.

The comparable non contingent bond relating to the bond in Example (3) would have the same issue price, initial interest payment and principal payment as the contingent bond and would bear interest after the first year, payable annually, at a fixed rate such that the yield of the comparable non contingent bond would equal the assumed rate. The \$140 premium would be amortized under a constant yield method over the life of the bond based on that yield. The difference between the assumed rate of interest and the actual LIBOR-based rate in any year would be reflected as an increase or decrease in the income for that year.

Finally, the comparable non contingent bond relating to the contingent bond in Example (4) would have a fixed rate of interest, payable annually, such that the yield of the bond, taking account of the \$200 discount, would equal the assumed rate. Appendix A shows the effect of the choice of an assumed rate on the rate of accrual of the discount.

It should be noted that section 1.1275-5 effectively adopts a comparable non contingent bond approach for variable rate obligations. Thus, where a variable rate obligation is issued at a discount below its principal amount, that discount is accrued, under section 1.1275-5(d)(2), as if the discount related to a hypothetical fixed rate bond which serves the same function as the comparable non contingent bond.

One important advantage that we see with the comparable non contingent bond approach is that it achieves results (including the requirement of accruing interest at the assumed rate until it is established that the actual yield differs from the assumed rate) that are as similar as practicably possible to the treatment of a wholly non contingent bond. As a consequence, less pressure is placed on the definition of a "contingent payment" and the ability to manipulate income by subjecting payments to relatively unimportant contingencies is reduced.

The major objection to the approach may be that because it gives effect to the particular terms of a contingent bond, it may be somewhat unpredictable and difficult to apply in practice. We do not believe, however, that the practical problems would be insurmountable, particularly if the regulations provided examples applying the method to the most common types of contingent payment obligations. It might make sense to refer in the regulations to the possibility that the IRS may adopt revenue rulings or revenue procedures applying the comparable non contingent bond approach to new types of contingent payment obligations that come into widespread use.

(b) Investment account approach. Under the investment account approach, a contingent payment bond would be accounted for in a manner similar to a credit card receivable. Thus, an account would be maintained for each contingent bond. The account would have a starting

balance equal to the issue price of the bond. At the end of each period, the account would be increased by the amount of interest that accrued during the period and decreased (but not below zero) by the amount of payments made during the period. The interest that accrues in each period would equal the product of the assumed rate (as defined above) and the balance in the account at the beginning of the period. To the extent that payments continued to be made after the account balance had been reduced to zero, they would be treated as additional interest (but would not be added to the account balance). The issuer and holders would report in each period (regardless of their accounting methods) the interest that accrued in that period and any additional interest attributable to payments made in that period. Holders would be allowed a loss deduction (which should be ordinary at least to the extent of interest previously reported on the bond), and the issuer would have ordinary income, equal to the balance in the account remaining after all payments on the bond have been made.<sup>86</sup>

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<sup>86</sup> A possible variant on the investment account approach described in the text would (i) increase interest income in a period to the extent that the minimum present value at the end of the period of all future payments on the contingent bond (calculated using the assumed rate as the discount rate and based on the lowest possible present value of any remaining contingent payments that have not yet become fixed) exceeded the balance in the account at the end of the period after giving effect to all other adjustments for the period and (ii) reduce interest income in a period to the extent that such account balance exceeded the maximum present value of all future payments (calculated using the assumed rate as the discount rate and based on the highest possible present value of any remaining contingent payments that have not yet become fixed).

Results under the investment account and comparable non contingent bond approaches would be the same in the case of a bond that provided for contingent payments that, in each case, became fixed in an amount equal to the corresponding payment on the comparable non contingent bond. Results would diverge, however, the first time that a contingent payment (or at least one that was not the only remaining contingent payment) became fixed in an amount that differed from the corresponding payment on the comparable non contingent bond. As discussed above, under the comparable non contingent bond approach, an adjustment would be made to reflect the difference between the two payments. By contrast, under the investment account approach, interest income would continue to be reported based on the assumed rate until it was established that the yield of the bond as a whole over its entire life would necessarily be greater or less than the assumed rate. We are fearful that deferring adjustments in this manner, and therefore not providing for "midcourse" corrections, could result in significant distortions of income from period to period. Such distortions would be particularly significant in the case of a bond that was publicly traded because of the likelihood that different taxpayers would own the bond at different times. For this reason, we prefer the comparable non contingent bond approach to the investment account approach.

To illustrate the possibility of distortions under the investment account approach, suppose that a bond that has an issue price of \$1,000 and a fixed

principal amount of \$1,000 payable in five years pays interest annually in an amount equal to a fixed percentage of the issuer's sales during the 12 months prior to the date on which interest is paid. Under the comparable non contingent bond approach, the net amount of interest income in each year would equal the amount of contingent interest for that year. By contrast, under the investment account approach, if the issuer had a particularly good first year, the interest income for that year would still be limited to interest at the assumed rate. Moreover, the interest payment in the first year would reduce the balance of the investment account to the extent the payment exceeded interest at the assumed rate; because income in future periods would be calculated by multiplying the account balance by the assumed rate, if the second year was as good as the first, the underreporting of income in the second year would be even greater than in the first year.<sup>87</sup>

(c) Dual security approach. A third possible approach would be to deal separately with the contingent

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<sup>87</sup> In order to further illustrate how the investment account approach may distort income, consider the consequences of applying that approach to a variable rate bond that provides for interest based on the current value of an objective interest index. Such a bond could be considered a type of contingent payment obligation, although in fact it would be governed by section 1.1275-5. As noted above, that section effectively adopts a comparable non contingent bond approach with the result that the interest income for each period reflects the variable rate of interest that is actually earned in that period. If the investment account approach were applied instead, interest income would be reported in each period based on the assumed rate until the basis of the bond was recovered or the bond matured, regardless of the variable rate actually in effect from time to time. This result would clearly be at odds with the conventional understanding of how a variable rate bond should be taxed.

and non contingent payments on a bond, as if they represented two different securities. Where an obligation is issued for cash, the portion of the issue price that is allocable to the non contingent payments would equal their present value using the assumed rate as the discount rate; interest would then accrue in respect of the non contingent payments at that rate. The balance of the issue price would be allocated to the contingent payments and would be recovered in some fashion as an offset to those payments. Income attributable to the contingent payments might be treated as non-interest income on the ground that the contingent payments, viewed as a separate security, do not represent payments in respect of indebtedness.

In one respect, the dual security approach and the comparable non contingent bond approach represent opposite extremes. Whereas the latter attempts to minimize the differences in treatment between a contingent bond and a wholly non contingent one, and therefore implicitly recognizes that both contingent and non contingent payments are made in respect of a single indebtedness, the dual security approach would strip contingent payments away from the non contingent payments and handle them under a non-debt regime. Thus, while each approach would require interest to be accrued at least initially at the assumed rate, this rate would be applied to the entire issue price under the comparable non contingent bond approach but only to that portion of the issue price which is allocated to the non contingent payments under the dual security approach.

We believe that the fact that some payments on a debt instrument are contingent is not, standing alone, a basis for divorcing those payments from the instrument and treating them as a non-debt security. On the other hand, we recognize that authority exists for treating some of the contingent payments on an instrument as payments in respect of an equity security (see, e.g., Farley Realty Corp. v. Comm., 279 F.2d 701 (2d Cir. 1960), and Richmond, Fredericksburg & Potomic Railroad Co. v. Comm., 528 F.2d 917 (4th Cir. 1975)), and, further, that the contingent features of a purported debt instrument can become so predominant that it will be characterized entirely as equity (see, e.g., Revenue Ruling 83-98, 1983-2 C.B. 40 (adjustable rate convertible notes treated as stock)). It is our understanding, based on the language quoted below, that the contingent payment rules in the Proposed Regulations are not intended to address classification issues but are limited in their application to debt instruments, and payments thereon, that are recognized to be debt, and payments on debt, under general tax law principles. Given that understanding, the comparable non contingent bond approach is clearly preferable to the dual security approach as a method for taxing contingent payment obligations of the type dealt with in the Proposed Regulations.

The Proposed Regulations state, at section 1.1275-4(a), that "[n]othing in this section or in the regulations under section 1271 through 1274 shall

influence whether an instrument evidences a valid indebtedness for Federal income tax purposes." This sentence implies that the Proposed Regulations will apply only to instruments that are considered to be valid indebtedness for such purposes, and we recommend that this be made explicit (although subject to a possible exception for contingent stock pay-outs in reorganizations, discussed in part III.8.D. below). We also suggest that the phrase "or whether payments on an instrument are treated as payments in respect of such an indebtedness" be added at the end of the quoted sentence, and that the sentence, as amended, be highlighted in the preamble to the final regulations.

(iii) Bull and bear bonds. Issuers have recently begun to issue "bull and bear" bonds which are unused in that they are non contingent obligations from the issuer's perspective but contingent as to individual holders. In a typical transaction, an issuer might issue simultaneously two classes of bonds, A and B, having the same initial aggregate principal amounts. The two classes would be identical, except that the principal amount of the A bonds (bull bonds) would increase with increases in a stock index (generally subject to a limitation such as 150% of the original principal amount of the A bonds) and the principal amount of the B bonds (bear bonds) would decrease in an amount equal to the increase in the principal amount of the A bonds. The A and B bonds together would be non contingent because changes in payments on one class would precisely offset changes in

payments on the other class, although either class alone would be contingent.

We believe that any contingent payment rules that are eventually adopted should provide symmetrical treatment of contingent increases and decreases in payments so that any income and losses that may be recognized by an issuer of bull and bear bonds as a result of their contingent features would be offsetting and the issuer would be left in the same position as if it had issued a single security combining the payments on both classes of bonds.

(iv) Fixed amounts payable at an uncertain time. Except in the case of debt instruments subject to section 1274, the Proposed Regulations do not specifically address instruments that provide for payments that are fixed in amount but contingent as to timing (for reasons other than the possible exercise of a call option by the issuer or a put option by the holders). One example of such an obligation is a bond that provides for a fixed principal amount that is payable no later than a certain maturity date but is subject to mandatory prepayment out of specified sources of funds or if specified conditions outside the issuer's control are met. Another example is a bond that provides for simple interest but allows the issuer to defer interest payments for a specified period or until maturity if cash flow is below specified levels. The deferred interest could be considered to be due when it is unconditionally payable, but subject to mandatory

prepayment if the conditions that allow deferral do not materialize.

Timing contingencies can readily be accommodated under either the comparable non contingent bond approach or the investment account approach. All that is needed is an initial assumption as to the timing of payments. We recommend that payments be considered initially to be payable at such times as will result in a yield to maturity equal to the assumed rate.

The justification for assuming initially that all timing contingencies are resolved so as to provide a yield equal to the assumed rate is that there is likely to be no other reasonable and administrable basis for estimating prepayment rates. Where this assumption is not true for a broad class of obligations, then an estimated prepayment rate should be used in accruing OID. This is the approach that will be applied to certain mortgage-backed securities under new section 1272(a)(6) (which was added to the Code by section 672 of TRA 1986).

(v) Sales or exchanges of contingent payment obligations. The Proposed Regulations provide no special rules for determining the character (as ordinary income or capital gain) of income recognized upon the sale or exchange of a contingent payment obligation. Gain from sale of a debt obligation generally would be attributable to one or more of the following factors: (i) accrual of interest or OID not previously included in income, (ii) an improvement in the financial condition or prospects of

the issuer, (iii) a decrease in market interest rates, or (iv) other general economic conditions not limited to the issuer. Such gain should be treated as ordinary interest income to the extent attributable to accrued interest or OID and as capital gain to the extent attributable to other factors.<sup>88</sup> Under either the comparable non contingent bond approach or the investment account approach, interest would be reported by holders of a contingent bond as it accrues based on the assumed rate. In light of this, we recommend that gain or loss from sale of a bond that is being taxed under one of these approaches be treated as capital gain or loss.

In the case of a contingent bond subject to paragraph (e) or (f), it would be appropriate to tax some portion of the gain on sale as ordinary income because of the strong possibility that some amount of such gain is attributable economically to accrued interest. The ordinary income component could perhaps be computed by reference to the amount of additional interest that would have been included in income by the seller if interest had accrued based on the assumed rate. Cf. section 860B(c), added by TRA 1986 (gain on sale of a REMIC regular interest taxed as ordinary income to the extent

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<sup>88</sup> Of course, gain attributable to accrued market discount would also be taxable as ordinary income under section 1276.

of the excess of accrued interest calculated at 110% of the applicable Federal rate over the amount of interest income previously reported by the seller).

(vi) Treatment of subsequent holders. The Proposed Regulations do not deal with the treatment of subsequent holders of a contingent payment obligation. If a subsequent holder purchases the obligation at a price equal to the basis of the obligation at the time of the purchase in the hands of an original holder, then the subsequent holder should report income in the same manner as an original holder. On the other hand, if the obligation is purchased at a greater or lesser price, a mechanism must be developed to take that difference (the "purchase adjustment") into account.

If a contingent bond is being taxed under the comparable non contingent bond approach, accounting for the purchase adjustment would be straightforward. It would be taken into account in the same manner as if the purchaser had acquired the comparable non contingent bond. By contrast, it is not obvious how the purchase adjustment should be handled in practice under either the investment account approach or the principles of paragraph (e) or (f).<sup>89</sup>

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<sup>89</sup> As a conceptual matter, the purchaser's basis, including the purchase adjustment, should be accounted for, with one substantive exception, in the same manner as if the obligation had been issued at a higher or lower price ("hypothetical issue price") such that its basis to an original holder at the time of the purchase would equal its initial basis to the subsequent purchaser. The one substantive exception to this rule would apply in the case of a subsequent holder who buys an obligation at a market discount and, under the rule

(footnote continued)

D. Contingent Stock Pay-Outs in Reorganizations.

Prior to the TRA 1984 amendments, if the requirements of section 483 were otherwise met, that section applied following a reorganization to contingent stock of the acquiring corporation that was issued over time, notwithstanding that the right to receive the contingent stock would not qualify as indebtedness under general tax principles. See section 1.483-1(b)(6), Example (8). By contrast, under the Proposed Regulations, in a case where the acquired corporation's stock is publicly traded at the time of the reorganization,\* it is not clear whether the value of any contingent stock that is ultimately issued in exchange for such publicly traded stock would be treated (i) as interest to the extent the value of the contingent stock exceeds the value of the stock for which it was exchanged, (ii) as interest to the extent of the amount of interest that has accrued based on the applicable Federal rate or (iii) not as interest to any extent. To resolve this issue, it is necessary to

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(footnote continued from previous page)  
described above, would be required to include the amount of such discount in income as it accrues before receipt. In that case, the reporting of such discount should be deferred until the payments to which the market discount relates are received (assuming the holder has not made an election under section 1278(b) to treat market discount as OID).

Section 1276 requires that market discount be taxed as ordinary income to the extent that such discount has accrued at the time when it is included in income. One way to apply this rule to a contingent payment obligation would be to measure accrued market discount at any time (the "determination time") as the excess (if any) of (i) the interest income that would be reported by an original holder after the date of purchase by the subsequent holder and through and including the determination time assuming issuance of the obligation at the hypothetical issue price over (ii) the interest income that would be reported by an original holder in that period based on its actual issue price.

consider the definition of "debt instrument" under section 1275 and the limitations on the application of sections 483 and 1274. Section 1.1275-1(b) defines a debt instrument to include "all rights to deferred payments under a contract whether or not evidenced by a formal instrument" and "an instrument calling for payments in the form of cash, stock, securities, or any other property (other than a debt instrument issued by the same obligor)." This definition could be read to encompass any right to contingent stock (since such a right would be a right to deferred payments in the form of stock). On the other hand, section 1.1275-4(a) cautions that nothing in the regulations under sections 1271 through 1275 shall influence whether an instrument calling for contingent payments is properly treated as debt or equity, or whether such instrument evidences a valid indebtedness for federal income tax purposes, which, as noted above in part III.8.C., would seem to imply that a deferred payment right must qualify as indebtedness for federal income tax purposes before it can be a "debt instrument" under section 1275. Under that view, a contingent right to stock would almost certainly not be such a debt instrument.

If a right to stock were considered a debt instrument and the right was traded or issued in exchange for traded stock, the results would be nonsensical. The issue price of the right would be determined under section 1273(b)(2) based on the market value of the right. Because the right would be contingent, the interest component of any stock issued there under would

be determined under paragraph (f). Consequently, the full amount of gain realized economically by the holders of the right (the excess of the value of the stock over the issue price of the right) would be taxable as interest income, apparently when the stock was issued,<sup>90</sup> even though any such gain might not be attributable to any significant extent to an interest factor.

If any portion of the value of stock issued under a contingent stock right is to be treated as interest, the interest component should instead be based on the applicable Federal rate applied to the value of the stock. However, neither section 483 nor section 1274 would apply if the stock right was treated as a debt instrument under section 1275 and its issue price was determined under section 1273(b)(1). See section 483(d)(1), as amended by TRA 1986, and sections 1.483-1(c)(2)(i), 1274(c)(3)(D) and 1.1274-1(b)(5).

On the other hand, if it was concluded that the stock right was not a debt instrument within the meaning of section 1275, then section 1274 would still not apply, but it appears that section 483 would apply. The operative language of section 483 does not require a debt instrument and the exception in section 483 (d)(1) for " any debt instrument for which an issue price is determined under section 1273(b) (other than paragraph (4) thereof) or section 1274" (emphasis added) could not

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<sup>90</sup> Presumably, payments under the right would be considered to become "fixed" as shares of stock were issued there under, although this is not certain.

be invoked.<sup>91</sup> While this approach would preserve prior law, the Treasury also may wish to reconsider the basic question whether it is advisable to treat payments under a deferred payment right as interest in a case where that right is not otherwise treated as indebtedness for tax purposes. If section 483 does continue to apply to contingent stock pay-outs, then imputed interest would not be included in income before the contingent stock is delivered. We believe that this result is appropriate.<sup>92</sup>

## 9. Variable Rate Debt Instruments.

A. Description. Section 1.1275-5 provides rules for debt instruments that bear interest "based on current values of an objective interest rate index". Interest that meets this standard will be referred to herein as "Qualified Indexed Interest". A variable rate instrument that provides for Qualified Indexed Interest is described in the Proposed Regulations as a "variable rate debt instrument", but, to avoid confusion with other variable

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<sup>91</sup> Although the language of section 483 does not require a debt instrument, the Proposed Regulations do not contemplate that section 483 would apply where section 1274 does not apply solely because of the absence of a debt instrument. Under section 1.483-1(a)(i), section 483 applies only if section 1274 does not apply because of one of the exceptions listed in section 1.483-1(c)(1) and the list does not include the absence of a debt instrument. Thus, a change in the regulations would be required to permit section 483 to apply under these circumstances.

<sup>92</sup> While we have generally recommended that holders of contingent payment obligations issued for cash or publicly traded property be required to report interest income as it accrues based on an assumed rate, this treatment was based on the understanding that the obligations qualified as indebtedness for federal income tax purposes. Because that would not be true in the case of a stock right, we would not recommend that this approach be followed for such rights.

rate obligations that fall outside of section 1.1275-5, will be referred to herein as a "Qualified Indexed Instrument". Obligations that provide for interest at a variable rate but that are not Qualified Indexed Instruments are subject to the contingent payment rules in section 1.1275-4.<sup>93</sup>

As noted above, Qualified Indexed Interest is interest that is (i) based on (ii) current values of (iii) an objective interest index.

Under section 1.1275-5(b), interest expressed as a fixed multiple of an objective interest index or as a constant number of percentage or basis points more or less than an objective interest index is deemed to be "based on" an objective interest index, whereas interest expressed as a fixed multiple of an objective interest index plus or minus a constant number of percentage or basis points is not deemed to be based on such an interest index.

The same paragraph (b) defines an "objective interest index" as either (i) "[a] rate which, as of the issue date of the debt instrument, is made known publicly and offered currently to unrelated borrowers in private

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<sup>93</sup> The relationship between the contingent payment rules and the rules in section 1.1275-5 is not clear in the case of an obligation that provides for some interest that is Qualified Indexed Interest and other contingent principal or interest payments. We suspect that section 1.1275-5 was intended to apply only to obligations that are contingent solely because they provide for variable interest that is entirely Qualified Indexed Interest, or because they provide for such interest and have an uncertain maturity, and recommend that this be made explicit.

lending transactions by a financial institution" (first definition), or (ii) "[a] rate which reflects an average (based on a statistically significant sample) of current yields on a class of publicly traded debt instruments" (second definition). The following examples are given of objective interest indices: the prime rate of a designated financial institution, LIBOR (London Interbank Official Rate), the applicable Federal rate and the average yield on Treasury securities as published in Federal Reserve bulletins.

Under section 1.1275-5(c), in the case of debt instruments issued after May 8, 1986, an interest rate is based on "current values" of an index if the rate during any accrual period is based on the values of the index in effect no later than the close of that accrual period and no earlier than three months prior to the beginning of the first accrual period during which such rate was in effect.

Under section 1.1275-5(d), interest that is Qualified Indexed Interest is taxable under the normal rules for stated interest, except that if such interest is not paid currently and therefore fails to be qualified periodic interest, then such interest is treated as OID and is includible in income and deductible as it accrues under the terms of the instrument. If the instrument has OID represented by the excess of its principal amount over its issue price, that discount accrues at the rate at which it would accrue if the instrument provided for stated interest at a fixed rate equal to the rate

established by the objective interest index on the issue date (or in a transaction to which section 1274 applies and for which there was a binding written contract prior to the issue date, on the contract date).

Finally, if a debt instrument provides for a fixed rate of interest during some accrual periods and a variable rate in other accrual periods, or one variable rate during some accrual periods and one or more variable rates based on a different index or formula in other accrual periods, the OID on the instrument is to be reallocated "in a manner consistent with the rules of sections 1272 and 1275 and the regulations there under to prevent the front-loading or back loading of interest". Section 1.1275-5(d)(4).

B. Comments.

We support the rules for Qualified Indexed Instruments which, in general outline, follow the 1983 Report at 1003. However, we have some technical comments.

First, we believe that interest should be considered to be based on an objective interest index if it is tied to such an index by some combination of addition or subtraction and multiplication. If the drafters were concerned that a measure of interest could be constructed through both multiplication and addition or subtraction that did not adequately track current interest rates (e.g., interest equal to 10 times the prime rate, less 90 percentage points, when the prime

rate is initially 10%), this problem should be addressed more directly, perhaps by requiring that interest be tied to an objective interest index in such a manner that it does generally reflect current interest rates as measured by that index. In any event, we have some doubts as to whether the problem, if we have properly identified it, is a real one in practice.<sup>94</sup>

The definition of Qualified Indexed Interest should also be expanded to include interest that is based on more than one objective interest index or different indices at different times. For example, it would not be unusual to compute interest based on an average, or the highest or lowest, of several indices. It is also quite common in private lending transactions to allow the borrower to fix an interest rate for different periods less than the remaining term of the loan, based on indices that reflects a market rate of interest for the period over which the rate is to be fixed but that may differ from indices used to set interest on the loan in other periods.<sup>95</sup> For example, a ten-year loan could provide initially for a floating rate based on LIBOR but allow the issuer to subsequently fix the rate for any

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<sup>94</sup> It should be noted that bonds have been offered publicly that provide for interest that decreases with increases in an objective interest rate. Although the purpose of the rate adjustment in the case of such bonds is obviously not to maintain a rate of interest that tracks current market rates, it may nonetheless be appropriate to apply the principles of section 1.1275-5 to such obligations.

<sup>95</sup> Section 1.1274-6(a)(2) appears to acknowledge this practice by providing that, in the case of a Qualified Indexed Instrument, the applicable Federal rate shall be determined by reference to the longest adjustment interval of the objective interest index rather than the term of the debt instrument.

period ending not later than the stated maturity date at a rate that represents a fixed spread over the point on the "Treasury curve" (the curve showing current yields on U.S. Treasury debt obligations having different remaining maturities) corresponding to the period for which the rate is to be fixed.<sup>96</sup> Because the issuer has the option to choose which index to use in setting the interest rate (in the example above, to continue with a floating rate or to fix the rate), there is some assurance that the available indices are expected by the parties to produce rates that equal current market rates at the times when they are set. Interest calculated under such arrangements should be Qualified Indexed Interest.<sup>97</sup>

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<sup>96</sup> If the rate was always set or reset based on the Treasury curve, it could be argued that the rate would be Qualified Indexed Interest even under the existing language of the Proposed Regulations on the ground that the entire Treasury curve (rather than any one point along it) is an objective interest index.

<sup>97</sup> One further issue that may arise in applying the Proposed Regulations to such arrangements is whether interest resulting there under is qualified periodic interest in cases where the spread over an index that is charged to the borrower is not the same for all of the indices that may be chosen. For example, the borrower might be allowed to set interest at a spread of x basis points over a prime rate, y basis points over LIBOR or z basis points over the Treasury curve at different times over the course of the loan (x, y and z being fixed at the time of initiation of the loan and not themselves variable). Provided that the variation in the spreads reflects market conditions rather than an attempt to backload or frontload interest, then the variation should not itself create any OID. The fact that the borrower is allowed to choose among the different indices again provides considerable assurance that the rates are expected to be current market rates. It should be noted that if both the borrower and lender were required to assent to a new rate (i.e., either one could cause prepayment of the loan for the same amount at any time when the rate is reset), then clearly there would be no OID under the Proposed Regulations for the period prior to the resetting of the rate attributable to interest for the period following the resetting of the rate, regardless of what spread

(footnote continued)

The Proposed Regulations appear to adopt the position that the existence of lifetime or periodic floors or caps on interest rates does not prevent interest from being based on an objective interest index, whether or not the floors and caps are evenly balanced above and below the rate of interest produced by the value of the index on the issue date and regardless of the size of the spread between that starting interest rate and the floors or caps.<sup>98</sup> This point is important and should be made explicit.

We also recommend that the definition of objective interest index be amended and expanded. The first definition, quoted above, raises a number of questions. First, it is not clear why the rate must be made known and publicly offered to borrowers "as of the issue date of the debt instrument". Most variable rate loan documents provide for alternative measures of interest if the index on which interest is originally based ceases to be available. If a new index is substituted for an old one under such a provision, why should it make a difference whether the new index was available as of the issue date of the instrument? Second,

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(footnote continued from previous page)  
over an index was used to calculate the new rate. See section 1.1272-1(f)(4) (put/call rule) and the 1983 Report at 1008, Example (3).

<sup>98</sup> Section 1.1274-3(d)(1) places certain restrictions on floors and caps for purposes of determining whether a debt instrument subject to section.1274 has adequate stated interest, but section 1.1274-3(d)(1) applies only if it is first determined that a debt instrument has Qualified Indexed Interest. Thus, the existence of floors and caps cannot preclude interest from being Qualified Indexed Interest.

we suggest that the words "as a basis for determining rates" be inserted before the phrase "offered currently to unrelated borrowers in private lending transactions". Some banks now publish, in lieu of a "prime rate", a "base rate" or "reference rate" that is used as a starting point for setting rates of interest on some loans but does not have the connotation associated with the term "prime rate" of the rate actually charged by a bank on loans to its most creditworthy commercial customers.

One example that is given of an objective interest index is LIBOR. It is not clear to us whether that index was intended to fall within the first definition of objective interest index or the second, but in either case some change in wording is required. LIBOR is typically defined as an average of rates at which the London offices of a group of banks offer to accept U.S. dollar deposits. Thus, it does not fall within the first definition because it is not a rate offered by the banks to borrowers but rather a rate at which the banks offer to borrow. Furthermore, it is typically not a rate offered by one financial institution but an average of rates offered by several institutions. LIBOR also does not fall within the second definition of objective interest index because the deposits to which the rate relates are not publicly traded.

The second definition of objective interest index is ambiguous. In particular, it is not clear whether "an average (based on a statistically significant

sample) of current yields on a class of publicly traded debt instruments" means an average of quotes from different dealers for a single security or an average of yields for a group of different securities. The latter interpretation seems more likely from the language, but might not allow as an objective interest index the yield, for example, on 6-month Treasury bills which clearly should qualify as an objective interest index based on an example in the Proposed Regulations (section 1.1274-3(d)(1)(v), Example (2)) and common sense. We see no reason why current market yields on a specified security or securities of a specified borrower should not qualify as an objective interest index, provided the yields consistently track general market interest rates. One example might be interest rates on Citicorp commercial paper.

As borrowing practices change, it seems likely that new indices will come into use that are not contemplated by the two definitions of objective interest index. We recommend that the definition be expanded to include "any other readily available index of current market interest rates for debt instruments of one or more borrowers". It could be made clear that the market in question must be sufficiently active, and not subject to unusual terms and conditions, so that the index reflects general market interest rates. Thus, the debt instrument(s) taken into account in the index should be non contingent and not have any conversion, exchange or similar rights.

Recently, debt instruments have been issued that provide for interest payable at rates set in auctions that occur periodically over the life of the instruments. The rate set in any auction is the rate that "clears" offers to buy and sell in the auction at a price equal to the outstanding principal amount of the debt instruments. Interest rates set through such an auction procedure should also be considered to be Qualified Indexed Interest.

As noted above, if section 1.1275-5(c) does not apply to a floating rate instrument, then the instrument will be subject to the contingent payment rules in section 1.1275-4. If those rules were based on the comparable non contingent bond approach, as we have recommended in part III.8.C. above, then it generally would make little difference whether or not interest was considered to be Qualified Indexed Interest. Thus, adoption of the comparable non contingent bond approach should significantly reduce concern over the definition of Qualified Indexed Interest.

Section 1.1275-5(d)(1) states that the excess of the stated interest that actually accrues under the terms of a variable rate debt instrument during an accrual period over any qualified periodic interest shall constitute OID for that period. The section should make it clear that if the amount of interest that is not qualified periodic interest cannot be determined in advance (for example because of payment caps), then the OID attributable to such interest will never be

considered to be de minimis because it is not susceptible to measurement under the de minimis rule. On the other hand, the normal de minimis rule should apply to any discount that can be measured in advance, such as discount represented by the excess of the principal amount of a debt instrument over its issue price or discount that arises because a fixed percentage of the interest payable in predetermined periods is not qualified periodic interest.<sup>99</sup> For discussion of the application of the definition of qualified periodic interest to variable rate loans subject to payment caps, see part III.13.C. below.

Under section 1.1274-5(d)(2), OID is accrued based on the terms of a hypothetical debt instrument that calls for fixed interest "at a rate equal to the rate established by the-objective interest index on the issue

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<sup>99</sup> To illustrate, suppose that a loan provides for interest payable quarterly at 50 basis points above the prime rate of a bank and a single principal payment after ten years and has an issue price equal to 98% of its principal amount. All of the interest is qualified periodic interest and the 2% discount is less than the de minimis amount of 2.5%. Accordingly, the loan should not be considered to have any OID. The result should be the same if the loan had an issue price equal to its principal amount and provided for interest of 75 basis points above the prime rate for the first two years and 50 basis points thereafter. Although the additional 25 basis points of interest payable in the first two years would not be qualified periodic interest, an aggregate amount of discount equal to .4975% of the stated redemption price at maturity (.5% of the principal amount divided by 100.5%) would be de minimis. However, if the loan further provided that any interest at an annual rate greater than 15% would be added to principal and paid at maturity, then interest that accrued but was not paid currently because of the cap should be treated as OID under section 1.1275 5(d)(1) without regard to the de minimis rule (although this possibility should not prevent the de minimis rule from continuing to apply to any other amounts of discount that can be measured in advance).

date, or, in a transaction to which section 1274 applies and for which there was a binding written contract prior to the issue date, the contract date." The definition of Qualified Indexed Interest allows a lag of up to three months (in the case of debt instruments issued after May 8, 1986) between the date on which an index is valued and the beginning of the accrual period to which it applies. The terms of the hypothetical debt instrument should take account of any such lag included in the terms of the actual instrument. It should also be made clear that if a bond issued for cash in a public offering is priced and sold on a date prior to the issue date, then the objective interest index may be valued as of the sale date rather than the issue date, at least if the rate for the first accrual period is set on that date as would ordinarily be the case. Cf. section 1.1273-1(b)(1)(ii)(B) which appears to allow a variable rate on a debt instrument to be valued as of the first day on which there is a binding written contract to sell the instrument even in the case of an instrument issued for cash. More generally, the fixed rate of interest on the hypothetical debt instrument referred to in section 1.1275-5(d)(2) should be the first rate of interest that actually applies to the instrument under its terms.

The rule in section 1.1275-5(d)(4) for debt instruments that switch between fixed and variable rate modes or use different formulae in computing interest in different periods is illustrated by one example (section 1.1275-5(d)(5), Example (5)). In the example, interest on a ten year note is paid semiannually at a rate equal to

the prime rate for the first five years and 150% of the prime rate thereafter. It is assumed that the prime rate is 10% on the issue date and remains frozen at that rate over the entire term of the note. Given those assumptions, the example states that the yield to maturity of the note is 11.802% and shows the resulting amounts of OID that accrue in the first ten semiannual accrual periods on account of the additional five percentage points of interest that is to be paid in the last ten accrual periods. The example states that the amount of OID allocable to each of the last ten accrual periods is the amount of interest actually payable for the accrual period, reduced by the portion of the payment treated as qualified periodic interest (five percent) and by the amount of OID allocated to the corresponding accrual period during the first five years.

The usefulness of this example is limited by the fact that the period during which interest is payable at the prime rate matches in length the period during which interest is payable at 150% of the prime rate so that the OID accruing in each of the former periods can be offset against the interest in the corresponding later period. What would be the result if this happy coincidence did not exist? We believe that the example would be more helpful in providing guidance in other situations if it stated that the interest income in each of the last ten accrual periods equals (i) the interest income (including OID) that would be reported if the interest payable on the note were fixed based on a value for the prime rate of 10% plus (ii) an amount (which may be positive or

negative) equal to the interest actually paid less the interest that would be paid if the prime rate were 10%. Under this approach, the income that would be reported by the holder of the note in the eleventh accrual period would be substantially the same as the \$60,988 (\$50,000 of qualified periodic interest plus \$10,988 of OID) indicated in the example.<sup>100</sup> It should be noted that the amount of income reported in the last five years could, under this revised formula or the approach in the example, be negative;<sup>101</sup> If so, either an ordinary loss should be allowed currently, or the loss should be permitted to be carried over as an offset against future interest income on the instrument.

The example should also be revised to state that the issuer of the note does not have the right to prepay the note. Otherwise the note might be considered to mature before its stated maturity date under the put/call rule in section 1.1272-1(f)(4).

The example assumes that the rate at which the OID that is paid in the last five years is accrued & n the first five years will always be based on the initial

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<sup>100</sup> The sum of the amounts of OID shown in the example for the first ten accrual periods is \$118,230. Adding this amount to the issue price of \$1,000,000 yields an adjusted issue price at the beginning of the eleventh accrual period of \$1,118,230. Thus, the amount of OID and qualified periodic interest that would be allocated to that period if the prime rate were 10% would be  $\$1,118,230 \times (.11802 \times .5)$  or \$65,987, which when reduced by the excess of the interest based on a prime rate of 10% (\$75,000) over the interest actually paid (\$70,000), produces a net amount of income of \$60,987.

<sup>101</sup> This would be true in the eleventh accrual period if the prime rate was less than 1.803%. Obviously, other examples can be constructed where there is a greater likelihood that a loss will occur.

value of the prime rate. We believe that some consideration should be given to the possibility of adjusting the rate of OID accruals periodically to reflect current values of the prime rate.

Additional comments on variable rate debt instruments may be found in part III.13.C. below.

10. Section 1274.

We have the following comments on the Proposed Regulations under section 1274:

A. Publicly Traded Property.

Section 1.1274-1(b)(5) states that section 1274 does not apply to any debt instrument to which section 1273(b)(3) applies, and therefore does not apply to any debt instrument issued in consideration for the sale or exchange of "publicly traded property". A conforming change in the definition of issue price in section 1.1273-2(c) is needed to make it clear that section 1273(b)(3) would apply to a debt instrument, not itself publicly traded, that is issued in exchange for publicly traded property other than stocks or securities. Perhaps the principal example of such other publicly traded property would be foreign currencies.

B. Excessive Interest.

Section 1.1274-1(d) deals with "excessive interest", i.e., the situation where the interest component of a debt instrument issued in exchange for property is overstated because the buyer prefers the tax treatment of interest payments to an increase in the basis of the purchased property<sup>102</sup> and the seller is either indifferent or suffers a tax penalty of lesser consequence. The tax penalty to the seller is generally the conversion of capital gain into interest, which will have limited significance once the changes in tax rates

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<sup>102</sup> While this would ordinarily happen where the acquired property is held for profit and is non depreciable or has a cost recovery period longer than the term of the debt instrument, in the case of the purchase of a personal residence, a buyer may be permitted to deduct interest but expect to derive no substantial benefit from a higher basis in the residence. However, because section 1274 does not apply to sales of principal residences, nor from the borrower's perspective to debt instruments given in consideration of the sale or exchange of personal use property (see section 1275(b)(1)), the overstatement of interest in this case would not be covered by section 1.1274-1(d). Perhaps an excessive interest rule should be adopted in the regulations to cover this situation that is not dependent on either section 1274 or section 483 (which also does not apply from the borrower's perspective to debt incurred to buy personal use property). One reason why the overstatement of interest may in any event be less of a practical problem than the overstatement of principal is that lenders are likely to be reluctant to permit "true principal" to be converted into interest because of a concern that they would not have a claim for unaccrued interest in the event the buyer encounters financial difficulty.

under TRA 1986 become fully effective.

Under the excessive interest rule, if interest on a debt instrument exchanged for property is clearly greater than the arm's length rate of interest that would have been charged in a cash lending transaction between the same parties, then the IRS may recharacterize a portion of the stated interest as additional purchase price. Presumably, the recharacterization would apply equally to the buyer and seller and the regulation should so state. The portion of interest to be recharacterized is to be "determined in a manner consistent with section 1274 and may be based either on the fair market value of the property sold or on the arm's length rate". We assume that this statement signifies that the issue price of the debt instrument would equal either the fair market value of the property, or the present value of payments on the instrument as of the issue date, calculated using the arm's length rate as the discount rate. In either case, the issue price would exceed the principal amount of the instrument, and the regulation should provide that this premium will be amortized over the life of the instrument under a constant yield method without the need for a holder election under section 171. See 1983 Report at 1031 and the amendment to section 171 in section 1803(a)(ii) of TRA 1986.

Under the normal rules of section 1274, the fair market value of property is used as the issue price only in "potentially abusive situations". No similar criterion for choosing fair market value over an arm's length rate

is provided in the excessive interest rule, but in the context of that rule the two approaches should be viewed simply as alternative methods for measuring an arm's length purchase price.

We believe that the imprecision of the excessive interest rule is acceptable as long as it is understood to be a rule for extreme abuse cases. That the rule is intended to be so limited is indicated by the reference therein to a "clearly" greater than arm's length rate and use of a 22% rate of interest on July 1, 1986 (275% of, and 14 percentage points above, the then prevailing Federal long-term rate of approximately 8%) to illustrate the rule (see section 1.1274-1(f), Example (4)). Section 1.1274-1(d) should include a cross-reference to this example.

C. Adequate Stated Interest.

Section 1.1274-3(c) sets forth standards for determining if there is adequate stated interest in cases where the debt instrument is issued in a potentially abusive situation or does not provide for interest payable at regular intervals over the life of the instrument at a rate at least equal to the test rate (see section 1.1274-3(b)). Such a debt instrument has adequate stated interest if its principal amount is less than or equal to the "testing amount". This in turn is defined as (i) the sum of the present values of payments on the instrument using the test rate of interest as the discount rate or (ii) in the case of a potentially

abusive situation, the fair market value of the property exchanged for the debt instrument.

This language could be read to mean that, in a potentially abusive situation, the test rate would be ignored and the testing amount would be determined solely by reference to the fair market value of the purchased property. While the potentially abusive situation rules rest on an assumption that the stated value of the property invariably would be inflated, so that the property's fair market value would always be less than the present value of payments under the debt instrument calculated using the test rate as the discount rate, the definition of potentially abusive situation is sufficiently broad so as to give no true indication of the presence of inflated values. If the definition of testing amount does assume that the fair market value of purchased property will be less than the present value of debt service payments in a potentially abusive situation, perhaps this should be made explicit by limiting the fair market value portion of the testing amount definition to circumstances where that is the case (or by changing the definition of potentially abusive situation).

D. Variable Rate Instruments.

Section 1.1274-3(d)(1)(iii) states that paragraph (d)(1) of that section will not apply to a debt instrument that "places a ceiling on the maximum rate of interest payable under the debt instrument" unless two tests (described below) are met. This provision seems to

be aimed at interest rate caps that apply over the entire life of an instrument and not limitations that apply in some periods because of restrictions on the maximum amount that interest rates can increase from one period to another. Limitations on period-to-period adjustments are already dealt with in paragraph (d)(1)(ii). If this was the intent, the language of paragraph (d)(1)(iii) should be amended to express it more clearly.

The two tests that must be met in order for an interest rate ceiling to be ignored are that (i) the excess of the rate initially fixed by the index over the test rate of interest plus the excess of the maximum rate permitted by the ceiling over the test rate is at least equal to five percentage points, and (ii) in the case of a debt instrument with a term that exceeds three years, the maximum rate permitted by the ceiling is at least equal to the test rate of interest based on the final maturity of the instrument plus the difference between that rate and the actual test rate (which, under section 1.1274-6(a)(2), would be based on the period between rate adjustments).

The first of these tests is equivalent to requiring that the average of the rate initially fixed by the index and the maximum rate exceed the test rate by 2.5 percentage points and would be more understandable if expressed in that way.

We are obliged to confess that the rationale for the second test escapes us. Perhaps the test is intended

to measure the likely variability of interest rates on the instrument so as to gauge the probability that the ceiling will be reached, but why the spread between shorter and longer term rates would provide useful information on that score is difficult to comprehend.

The next to last sentence in Example (2) at section 1.1274-3(d)(v) refers to an "annual adjustment period." The word "semiannual" should be substituted for "annual" to conform to the facts given in the example.

E. Potentially Abusive Situations.

Section 1.1274-4(g) defines a potentially abusive situation as a tax shelter (with a cross-reference to section 6661(b)(2)(C)(ii)) or any situation involving a recent sales transaction, nonrecourse financing, financing with a term in excess of the economic life of the property, or a sale in which the purchase price or the interest thereon is denominated in a currency other than the U.S. dollar. The last item in the list is the only case in which the drafters of the Proposed Regulation responded to the Congressional delegation of authority in section 1274(b)(3)(B) to specify "other circumstances having potential for tax avoidance."

In a potentially abusive situation, where the fair market value of property sold for a debt instrument and other consideration is less than the sum of the principal amount of the instrument and the fair market

value of the other consideration (so that the instrument does not have adequate stated interest), then the issue price of the instrument is considered to be the fair market value of the property reduced by the fair market value of the other consideration. Sections 1.1274-4(a) and (g). Under the Proposed Regulations, the yield to maturity of the instrument would then be computed based on the issue price of the instrument and all payments to be made thereon (section 1.1272-1(f)(3)(i), last sentence). Thus, by contrast with the normal rules of section 1274 that allow taxpayers to state interest at any rate they choose between the applicable Federal rate and a clearly excessive rate, they are forced to treat a debt instrument issued in a potentially abusive situation as if it bore interest at an arm's length rate.

These results are appropriate if the "potential abuse" to be combatted is the understatement of the interest component of a debt instrument as compared with interest computed at an arm's length rate. However, we question whether the drafters had that problem primarily in mind; the possible understatement of interest as compared with an arm's length rate is potentially present in all transactions subject to section 1274, not just those that have been identified as potentially abusive.

It is more likely that the practice at which the anti-abuse measure was aimed is the exchange of a debt instrument for property where the instrument is

overstated in terms of both interest and principal.<sup>103</sup> The appropriate response to the problem of overstated principal and interest would be to ignore the overstated payments unless and until they are paid and not simply to drop the issue price.<sup>104</sup> However, this result is not mandated by section 1274 or even mentioned as a possibility in the Proposed Regulations.<sup>105</sup>

We are left with the impression that the potentially abusive situation rules rest on a somewhat shaky conceptual foundation because the abuse at which they seem to be directed (debt instruments that will not be paid) is not dealt with adequately by section 1274, and the actual effect of the rules as described in the

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<sup>103</sup> This would explain the inclusion in the list of potentially abusive situations of nonrecourse financing and financing with a term in excess of the economic life of the property.

<sup>104</sup> The discussion of the potentially abusive situation rule in the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 119, supports this approach.

<sup>105</sup> The regulations under section 1274 should at least include a statement to the effect that it is at all times assumed in the regulations that a debt instrument is recognized to be a debt instrument for federal income tax purposes, perhaps with a pointed reference, in the context of potentially abusive situations, to Estate of Franklin v. Comm., 544 F.2d 1045 (9th Cir. 1976), and other similar authorities. As has already been noted in other contexts, section 1.1275-4(a), last sentence, states that nothing in the regulations under sections 1271-1275 shall influence whether an instrument calling for contingent payments is properly treated as debt or equity, or whether such instrument evidences a valid indebtedness for federal income tax purposes. However, this sentence would not literally apply to a debt instrument that is contingent because it is likely to go into default in view of the statement in section 1.1275-4(b)(1) that "[a] payment shall not be considered a contingent payment merely because the amount of or the liability for the payment may be impaired by insolvency or default."

Proposed Regulations, to require use of an arm's length rate of interest rather than a rate not below the applicable Federal rate or clearly excessive, is potentially present in all seller financed sales of property subject to section 1274.

The list of potentially abusive situations in the Proposed Regulations includes a sale in which the purchase price or interest thereon is denominated in a currency other than the U.S. dollar. The purpose of this inclusion is not clear to us. The usual concern with a foreign currency borrowing is that interest deductions will be overstated if the currency is that of a country suffering from high inflation rates. Since the applicable Federal rate and an arm's length rate of interest in such a currency would take account of expected inflation rates, we do not see that how section 1274 would address the problem even if the potentially abusive situation rules applied. In any event, a transaction should not be considered to be potentially abusive where debt is incurred in a foreign currency that is the functional currency for the borrower as defined in new section 988.

F. Applicable Federal Rate.

Section 1.1274-6(c) provides a rule for determining the applicable Federal rate for a debt instrument "the proceeds or repayment of which" is denominated in a foreign currency. If payments on an instrument are denominated in U.S. dollars, but its "proceeds" (presumably the monies advanced in exchange

for the instrument) are denominated in a foreign currency, why should the normal definition of applicable Federal rate not apply? This is, in any event, a problem only where the foreign currency is not publicly traded. If the debt instrument were exchanged for publicly traded foreign currency, section 1274 would not apply.

Section 1.1274-6(d) provides special guidance in determining the applicable Federal rate for an installment obligation. The complication arises from the fact that different rates apply depending on the maturity of a debt instrument and in the case of an installment obligation, principal is payable at more than one time. The thrust of the rules is that the applicable Federal rate is a weighted average of the rates that would apply to each installment of principal and related interest if it stood alone. Under the Proposed Regulations, the calculation can be made under tables, in the case of self-amortizing installment obligations and level principal obligations, or using a more precise method. In any event, if an installment obligation bears interest at a rate at least equal to the applicable Federal rate which applies to the final maturity of the obligation, it has adequate stated interest. (The assumption here is that longer-term rates will be higher than shorter-term rates, and where that is not the case, the IRS can ignore nominal payments of principal that extend the maturity of an installment obligation (see section 1.1274-6(d)(1)(ii), Example (2)).) If it is determined that an installment obligation does not have adequate stated interest, then the imputed principal amount is determined

by reference to the last payment of principal, with the IRS again having the power to disregard nominal principal payments.

This is an area where we believe that the Proposed Regulations, which are complex by any standard, have given too little weight to the desire for simplicity. A number of compromises were made in defining the applicable Federal rate, and it should be recognized that it represents at best an approximation of a current market rate.<sup>106</sup> Seen in that light, we believe that the apparent precision that is gained through the proposed method of computation of the applicable Federal rate for installment obligations is largely illusory.

We recommend as a simpler alternative that the applicable Federal rate for an installment obligation be determined by substituting for its maturity date its average weighted maturity, calculated as under section 1.1273-1(a)(3)(ii)(A) but taking account of fractional parts of a year, in the manner recommended above in part III.4.B. A rule could be adopted for obligations that pay principal at least as quickly as a self-amortizing installment obligation that would allow 2/3 of the stated

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<sup>106</sup> For example, the applicable Federal rate can be significantly different for an obligation with a term of three years and one day as compared with three years even though market rates would be the same, and the same rate applies to all obligations having a maturity between three and nine years. Also, the rate is the lowest rate over a three-month period and is calculated as 100% (rather than some other percentage that could have been chosen) of Treasury rates.

maturity date to be substituted for the weighted average maturity.<sup>107</sup>

A test based on the average weighted maturity has two benefits. First, the average weighted maturity of an obligation is often calculated for nontax reasons and therefore is likely to be readily available to taxpayers. Second, since there would be only one way of determining the applicable Federal rate, the same rate could be used both in testing whether an obligation has adequate stated interest and, if it does not, in calculating the imputed principal amount. We do not think it is appropriate under section 1274 as now written to use different rates for these purposes, as the Proposed Regulations would do.

In the event our recommendation is not adopted, then we have one comment on the calculation of the testing amount under section 1.1274-6(d)(3). In general, that paragraph requires that the interest associated with a principal payment be present valued using the applicable Federal rate associated with the term of that principal payment. Was it intended that this rule would apply even where such interest is not qualified periodic interest? It would seem to be more in keeping with the spirit of the Proposed Regulations to treat interest that is not qualified periodic interest as additional principal.

G. Certain Options.

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<sup>107</sup> The proposed 2/3 rule parallels the safe-harbor de minimis rule in section 1.1273-1(a)(3)(ii)(B) (2/3 is 1/6 divided by 1/4).

Section 1.1274-6(f) contains certain presumptions as to the exercise of seller or buyer options. The presumptions generally conform to the put/call rules in section 1.1272-1(f)(4), except that the test is phrased in terms of maximizing the testing amount (rather than the yield) in the case of a seller option and minimizing the testing amount (rather than the yield) in the case of a buyer option. One consequence of this change is that different applicable Federal rates may apply in determining the present values of payments on debt instruments depending on whether or not an option is exercised.

We have a number of comments on this section. First, the section does not state that an option that is not presumed to be exercised is presumed not to be exercised. This should be added. Second, rules for subsequent adjustments modelled after section 1.1272-1(f)(4)(iv) should be added (with a clarification that section 1274 will not be applied again to test the adequacy of stated interest on any new debt instrument that is deemed to be issued on an option exercise date). Third, in the case of a debt instrument issued in a potentially abusive situation, the testing amount may be the fair market value of the property for which the instrument is exchanged, regardless of whether an option is or is not exercised. In circumstances where the testing amount of a debt instrument is fixed regardless of the payments on the instrument, perhaps a put/call rule based on yield along the lines of section 1.1272-4(f) should be used. Finally, many of our comments on the

put/call rule in section 1.1272-4(f) (see part III.3.C. above) are also relevant here.

H. Modifications and Assumptions.

Section 1.1274-1(c)(1) provides that if the parties "modify" a debt instrument, the modified debt instrument shall be treated as a new debt instrument given in consideration for the unmodified (old) instrument. Because the old instrument is property, section 1274 generally will apply to the new instrument, based on the applicable Federal rates in effect at the time of the modification, unless one or the other of the instruments is publicly traded. Whether or not the old instrument was issued for cash or property is irrelevant.

In general, an instrument is considered to be modified if there is a deemed exchange of the new instrument for the old one under section 1001. However, paragraph (c)(1) adds that a payment to or from the lender (or a successor) not provided for in the debt instrument will be treated as a modification of the debt instrument.

An example illustrating the rule is found in paragraph (c)(2). In the example, the issuer and holder agree to change the rate of interest on a debt instrument. According to the example, this change "constitutes a modification under § 1.1001-1(a)." Therefore, the issuer is considered to give a new debt instrument in exchange for the old one.

We agree that section 1274 applies to a modification that is treated as an exchange of a new instrument for an old one under section 1001. However, we do not believe that the section 1274 regulations are an appropriate place to revisit the question of what change in terms amounts to a deemed exchange. Therefore, we recommend that the example in paragraph (c)(2) and the examples in section 1.1274-7 state that there has been a modification without describing exactly what changes have taken place.

We also question whether a payment to or from the lender not provided in the terms of the debt instrument should always be regarded as a modification. For example, suppose that the issuer of a debt instrument prepays a portion of the principal balance of the instrument with the holder's consent at a time when the prepayment would not be permitted without such consent. Such a prepayment would ordinarily be viewed simply as a partial retirement of the instrument. Treating the transaction as a taxable exchange under section 1001 of the portion of the instrument that remains outstanding for itself would, in our view, represent a unwarranted change in law.<sup>108</sup>

Under section 1.1274-7, section 1274 will not apply to a debt instrument assumed or taken subject to in

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<sup>108</sup> Payments by or to lenders are treated as modifications only if they are not "provided for" in the debt instrument. What does this mean? Would it be enough if the instrument stated that it may be prepaid with the lender's consent which will not be unreasonably withheld or with a "fair market value" prepayment penalty to be agreed to at the time of the prepayment?

connection with a sale or exchange which occurs after June 30, 1985, unless the debt instrument is modified as part of the sale or exchange. If it is modified, the modification will be treated as a "separate transaction" taking place either immediately before or immediately after the sale or exchange. The modification will be considered to occur before the sale or exchange unless the seller neither consents to nor participates in the modification.

One curious feature of the modification and assumption rules is that, while they identify when an exchange of one debt instrument for another will be deemed to occur, neither the statement of the rules nor the examples describe the consequences of that exchange. Those consequences would appear to be as follows:

In the case of a modification that is not part of an assumption, if section 1274 has the effect of reducing the issue price of the new debt instrument to below the issue price of the old debt instrument, then the issuer would potentially recognize discharge of indebtedness income equal to that difference (which will be referred to as the "discharge amount").<sup>109</sup> Such a reduction could occur, if the issuer is a corporation, only if the exchange is not considered to be part of a plan to recapitalize the issuer; if it were part of such

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<sup>109</sup> Section 822 of TRA 1986 repeals the general rule allowing solvent taxpayers to defer income resulting from the discharge of "qualified business indebtedness" by reducing the basis of depreciable property. However, section 108(e)(5), which treats a reduction in purchase money debt of a solvent taxpayer as a purchase price adjustment, has been retained.

a plan, section 1275(a)(4) would prevent the issue price of the new debt instrument from dropping below the revised issue price of the old instrument. (Section 1275(a)(4) is discussed in part III.4.E. above.) The holder would recognize gain or loss on the deemed exchange unless section 354 applies.

Turning to modifications occurring in connection with an assumption, if the modification occurs immediately prior to the sale and there is a discharge amount, the consequences for the seller would be the recognition of ordinary income equal to the discharge amount and a corresponding decrease in the gain, or increase in the loss, resulting from the sale (which could be capital gain or loss). In an era where the top rates for ordinary income and long-term capital gain are the same, a conversion of capital gain to ordinary income would be of little concern to the seller unless it had capital losses, although the combination of ordinary income and a potentially nondeductible capital loss could be quite adverse. If the modification occurs immediately after the sale, then it might be expected that the buyer's basis in the property would be reduced, because of the modification, by the discharge amount and that the buyer would be entitled over time to larger interest deductions (in the form of OID) in the same amount. However, section 1.1274-7(a)(2) states that the modification shall be treated as a "separate transaction", which could mean that the buyer keeps the higher basis in the property and has discharge of

indebtedness income equal to the discharge amount.<sup>110</sup> Inasmuch as the modification occurs as "part of" the sale or exchange, treatment of the modification as a separate transaction is very questionable. Moreover, if the buyer would be harmed by the tax effects of a post-sale modification and the seller would not be adversely affected by a pre-sale modification, well advised buyers will ensure that the seller participates in some fashion in the modification and unwary buyers will be unjustifiably harmed.

Regardless of when the modification occurs, the consequences for the holder of the debt instrument would be as described above. Presumably, the buyer's assumption of the debt instrument, either before or after the modification, would not be a taxable event to the holder.

In the first sentence of section 1.1274-7 and in other places in the Proposed Regulations, the expression "debt instrument assumed or taken subject to in connection with a sale or exchange" is used. That usage is incorrect. The debt instrument is not taken subject to; the property is taken subject to the debt instrument. Thus, the phrase should read: "a debt instrument assumed or subject to which the property is taken in connection with a sale or exchange"

#### 11. Section 446.

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<sup>110</sup> The modification could not be considered a purchase price adjustment under section 108(e)(5) because the debt would not be purchase money debt as to the new purchaser.

A. In General.

Section 1.446-2 prescribes new rules governing the method of accounting for interest in lending and deferred payment transactions that fall outside of sections 1272 and 1274. Thus, the rules apply to (i) loans of any size that do not have OID, (ii) loans with OID excepted from section 1272,<sup>111</sup> (iii) loans having unstated interest under section 483 and (iv) cash method debt instruments described in section 1274A.

For purposes of determining how payments under a debt instrument are allocated between interest and principal, section 1.446-2(d) provides that a payment subject to section 1.446-2 is treated: first, as a payment of interest to the extent interest has accrued and remains unpaid as of the date of the payment; second, as a prepayment of interest to the extent the parties have allocated more interest to payments than the amount of interest that has accrued as of the date of payment; and, third, as a payment of principal. Section 1.446-2(d)(3) provides, however, that in certain small transactions, the allocation by the parties of less interest to a payment than the amount of accrued interest that remains unpaid as of the date of payment will be respected. Under section 1.446-2(b), interest can accrue only at a single rate equal to the yield to maturity, as defined, of the debt instrument, regardless of any contrary agreement reached by the parties to the instrument. Prepayments of

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<sup>111</sup> For instance, the rules apply to an OID loan of not more than \$10,000, made between natural persons, if such loan is not made in the course of a trade or business of the lender. See section 1272(a)(2)(E).

interest are includible in income by the recipient but, except for prepaid interest in the form of points on home mortgages described in section 461(g)(2), interest is not deductible by the borrower until such interest accrues.

B. Overall Comments.

Section 1.446-2 adopts the economic accrual method to determine how interest accrues without a specific statutory direction to do so. Nevertheless, that method may be justified either as an exercise of the power of the IRS to require the use of an accounting method that clearly reflects income<sup>112</sup> or, perhaps, simply as a statement of normative principles of interest accrual.<sup>113</sup> Moreover, the same method is reflected in the TEFRA and TRA 1984 amendments to the OID provisions of the Code. We support the method's adoption.

We believe that the Proposed Regulations should apply the economic accrual principle more consistently by (i) requiring that all scheduled payments on a loan be divided between interest and principal based on an economic accrual method regardless of the labels applied to the payments under the terms of the loan and (ii) treating prepayments (regardless of whether designated interest or principal by the parties) generally in the same manner as described in part III.6. above, subject to a de minimis rule for prepayments that are made not more than three months before they are due.

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<sup>112</sup> Section 446 (b)

<sup>113</sup> Revenue Ruling 83-84, 1983-1 C.B. 97.

More particularly, we recommend adoption of the following rules:

(1) Interest on a loan would accrue based on the yield to maturity of the loan (as defined in section 1.446-2(c)(1)). The amount of interest accruing in any accrual period would be determined by multiplying the yield to maturity by the outstanding loan balance. The outstanding loan balance would be defined as in section 1.446-2(c)(3), except that in the event of a prepayment of principal or interest (other than a prepayment for a de minimis period as described in (3) below), the outstanding loan balance would be reduced to the present value of the future scheduled payments on the loan, determined using the yield to maturity as the discount rate. A prepayment would be defined as a payment that is made before the beginning of the accrual period in which it is scheduled to be made

(2) A scheduled payment (regardless of how designated under the instrument) would be treated as a payment of interest to the extent it did not exceed the amount of accrued and unpaid interest as of the date of payment and otherwise would be treated as a nontaxable principal payment that would reduce the loan balance. Accrued and unpaid interest would be defined, essentially as in section 1.446-2(d)(2), as the excess of the aggregate amount of accrued interest over the aggregate amount previously treated as interest.

(3) A prepayment (regardless of how designated under the instrument) would again be treated as a payment of interest to the extent of the accrued and unpaid interest. The payment would next be treated as a nontaxable principal payment to the extent necessary to reduce the loan balance to the outstanding loan balance described in (1) above. The remainder of the prepayment, if any, would be treated as gain from retirement of the loan. If the prepayment, after reduction for the amount representing interest, was not sufficient to reduce the loan balance to the outstanding loan balance immediately following the prepayment as so determined, then the holder would realize a loss from retirement of the loan equal to that difference.

(4) Finally, if a prepayment occurs and the period of the prepayment does not exceed a de minimis period (we suggest three months) then the prepayment will be treated by the lender and borrower in the same manner as the scheduled payment that is prepaid except that any portion of such payment that would be interest if paid when due would be deductible by the payor only on such due date.

We believe that the above rules would represent an improvement over section 1.446-2 because they (1) insure that interest will be reported consistently by the borrower and lender except with respect to de minimis prepayments, (2) provide guidance as to the treatment of

principal pre payments, and (3) ensure that interest will be reported under an economic accrual method regardless of the terms of the loan. We anticipate that most prepayments that would occur in practice either would fall within the de minimis period -- the most typical example would be a one or two month prepayment made in anticipation of an absence from home -- or would not be made prior to the beginning of the accrual period in which due (and therefore would not be a prepayment, as defined).

C. Particular Comments.

(a) Section 1.446-2(a).

Section 1.446-2(a)(1) states that the section applies to all amounts treated as interest in any lending or deferred-payment transaction with certain exceptions. Section 1276(a)(3) treats gain upon the disposition of market discount bonds as interest for purposes of the Code, with certain exceptions that are not relevant here. We do not believe that amounts treated as interest under section 1276 should be subject to section 1.446-2 (but rather should be subject to regulations under section 1276 that are, we understand, being prepared) and recommend that an appropriate exception be added in the section 446 regulations.

We think that subparagraph (2) of paragraph (a) should be amended by adding a sentence clarifying that cash method taxpayers are not, by virtue of the rules of

section 1.446-2, required to use the accrual method of accounting for interest. This question may arise because of the references to the accrual of income in section 1.446-2(b) and elsewhere in the regulation. A statement should also be added to the effect that accrual method taxpayers must compute accrued interest in accordance with the regulation, and that nothing in the regulation shall require or per it the double counting of interest income or expense that is paid after it has accrued.

(b) Section 1.446-2(b).

Section 1.446-2(b)(1) should state how interest is to be allocated within an accrual period. Thus, assume that in a lending transaction described in section 1272(a)(2)(E) (relating to certain loans between natural persons), A lends B \$10,000 repayable in one year with interest of \$1,000. Assume that the loan is made on September 1, 1986. Assume that both A and B are accrual method, calendar year taxpayers. How much interest must A recognize as income for 1986 and how much interest may B deduct? Presumably, interest would ordinarily accrue ratably within an accrual period as under section 1272(a)(3).

To be consistent with section 1.483-2(b)(2)(i), we believe that paragraph (b)(2)(ii)(A)(2) should include, as an example of another reasonable method, monthly compounding at the end of each month, with simple interest within a month.

(c) Section 1.446-2(c).

The first sentence of section 1.446-2(c)(2)(i) is ambiguous. The thought should be expressed more clearly that if compounding occurs at regular intervals of one year or less, such interval is the accrual period irrespective of whether payments occur at longer intervals. Thus, for instance, a loan would qualify for treatment under clause (i) if it provided for semiannual compounding and a single payment of accrued interest and principal at the end of the term (e.g., 2 years) of the loan.

We are also uncertain as to the significance of the parenthetical language in the phrase "more than one payment or compounding date (other than the date of the loan)" in clause (i). We assume that the parenthetical language refers to the payment of points on the loan origination date. If so, that should be made clear.

(d) Section 1.446-2(d).

We would change the rules for allocating payments between principal and interest as described above in our overall comments.

(e) Section 1.446-2(g).

The second clause of Example (6) states that: "At a rate of 9.20 percent, compounded annually, the present value of the five deferred payments and the six

payments of stated interest is \$139,819.50." Our calculations show that the present value is \$139,819.52.

Clauses (iii) and (iv) in Example (8) indicate that prepayments of interest for the first and second periods, respectively, are deductible as interest accrues in the second and third periods, respectively. Perhaps the language of those two clauses should be amended to make it clear that a prepayment of interest is not necessarily deductible in the immediately following period. Thus, if one were to prepay all of the interest on a multi-year loan subject to section 1.446-2 in the first year of the loan, interest would only be deductible as it accrues, and thus it would not all be deductible in year two of the loan.

For comments on the treatment under section 1.446 of "rule of 78s" and other consumer loans, see part III.13. below.

12. Section 483.

A. Application.

Section 483 applies only to certain deferred payment sales or exchanges of non-publicly traded property to which section 1274 does not apply.<sup>114</sup> Thus, interest may be imputed under section 483 only in connection with: the sale or exchange of a farm if the

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<sup>114</sup> Under section 483(d)(1), as amended by section 1803(a)(14)(B) of TRA 1986, section 483 does not apply to any debt instrument for which an issue price is determined under section 1273(b) (other than paragraph (4) thereof) or section 1274.

sales price does not exceed \$1 million, sales involving total payments of \$250,000 or less, sales of principal residences, qualified sales of land, and "cash method debt instruments" as defined in section 1274A with a principal amount of \$2,000,000 or less, all of which are excepted from the application of section 1274.<sup>115</sup>

Section 483(c)(1) provides that section 483 will apply only to deferred payment transactions involving the sale or exchange of property if the contract for sale provides for payments due more than one year after the date of the sale or exchange and, under the contract, there is "total unstated interest." Under section 1.483-1(a)(1), there will be total unstated interest under a contract only if the contract does not provide for "adequate stated interest" (within the meaning of section 1.483-2).

Apparently, the non statutory term "adequate stated interest" has been adopted in the Proposed Regulations to create greater conformity between sections 483 and 1274. A contract that does not have adequate stated interest, however, will not necessarily carry an equal amount of unstated interest.

A contract generally provides for adequate stated interest if it calls for interest over its entire term at a rate no lower than the "test rate" of interest

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<sup>115</sup> It may also be appropriate to apply section 483 to certain contingent stock pay-outs in reorganizations, as discussed in part III.8.D.

applicable to the contract. Section 1.483-2(a). If a contract does not provide for a fixed rate of interest at least equal to the test rate of interest (or is a cash method debt instrument issued in a potentially abusive situation), however, the contract has adequate stated interest only if the stated principal amount of the contract is less than or equal to an amount (which may be referred to as the "testing amount") which is the sum of the present values of all payments of principal and interest due under the contract, determined by discounting the payments at a rate equal to the test rate of interest (or in the case of a cash method debt instrument issued in a potentially abusive situation, the fair market value of the property sold, reduced by the fair market value of consideration other than the debt instrument given in exchange there for).

Where interest is found to be inadequate, a second computation must be performed in order to calculate the amount of unstated interest. Section 1.483-1(a)(2)(i). The unstated interest is the excess of the principal amount of a contract over an amount computed in the same manner as the testing amount referred to above except that present values are determined using the "imputed rate" of interest applicable to the contract.

The terms "test rate" and "imputed rate" are defined in section 1.483-4. Except in two special cases (certain sales of principal residences and sales and exchanges occurring before July 1, 1985) test rates and imputed rates are identical.

The Proposed Regulations contain special rules for variable rate obligations (sections 1.483-2(d) and -3(c)) and contingent payment obligations (sections 1.483-2(e), -3(d) and -5) that parallel those under section 1274.

B. Overall Comments.

On the whole, we agree with the interpretation of section 483 in the Proposed Regulations. As noted above, the Proposed Regulations make use of the concept of "adequate stated interest" in determining whether section 483 applies. That term cannot be found in section 483, but has instead been borrowed from section 1274. Because Congress has indicated that, for purposes of section 483, interest is to be allocated (and calculated)<sup>116</sup> pursuant to the rules relating to OID, we think it an appropriate interpretation of section 483 to determine the existence of unstated interest by determining whether a contract for the sale or exchange of property provides for adequate stated interest. With one exception discussed below, we agree that a contract for the sale or exchange of property that does not provide for adequate stated interest contains unstated interest.

C. Section 1.483-1.

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<sup>116</sup> Section 483(b) provides that, for the purpose of determining total unstated interest, present values are to be determined pursuant to the rules of section 1274(b)(2) and using a discount rate equal to the applicable Federal rate determined under section 1274(d).

We think that the last sentence of section 1.483-1(a)(2)(i), dealing with rules relating to the method of accounting for stated and unstated interest, should be set off as a separate clause entitled "Accounting for interest." Since the reference is to regulations issued under a different Code section, and since the rules referred to are important, we think that the reference should be highlighted.

The references in clauses (i), (ii) and (iii) of section 1.483-1(c)(1) to section 1274(c)(4) should be to section 1274(c)(3) (to reflect the amendment of section 1274 by P.L. 99-121).

D. Section 1.483-2.

We question in section 1.483-2(b)(3), Examples (6) and (7), whether the short period from May 20, 1986 through June 30, 1986 is not 40 days under a 30-day month/360 day year convention (30-20 plus one month of 30 days), rather than 42 days as indicated in the examples.

Under section 1.483-2(c) a contract has adequate stated interest only if the sum of the deferred payments due under the contract does not exceed the sum of the present values of the deferred payments and any stated interest payments due under the contract. Under subparagraph (c)(3), in determining present values, the amount of discount for a short period may be calculated using the approximate method prescribed in section 1.1274-5(d)(2)(iii) or any other reasonable method. Under

section 1.483-3(b), however, only the exact method described in section 1.1274-5(d)(2)(ii) may be used to determine unstated interest. We question why only the exact method may be used to determine unstated interest when other methods may be used in testing for adequate stated interest.<sup>117</sup> We recommend that the two provisions be conformed.

The language of section 1.483-2(d)(2)(ii) is difficult to understand. That language is similar to the language in section 1.1274-3(d)(1)(ii)(B) and appears to exclude the application of the rule found in section 1.1274-6(a)(2) in determining the test rate of interest if a change in rate follows too slowly a change in the index rate. Although we do not see that as an inappropriate rule, we think that it could be better articulated.

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<sup>117</sup> The approximate method will always produce a present value somewhat lower than that produced using the exact method. Thus, a situation could arise where section 483 would apply to a contract because the contract did not provide for adequate stated interest, yet the amount of unstated interest on the contract would be zero. Thus, consider the facts of section 1.483-2(c)(4), Example (1), with the following change: the contract for sale calls for a lump-sum payment of \$151,178.12 (consisting of \$60,000.00 sales price and \$91,178.12 payment of interest) due in 10 years and 6 months. The contract does not call for adequate stated interest using the approximate method to determine interest for the short period, because, at a discount rate of 9.2 percent, the present value of the deferred payment and interest payment is \$59,941.95. The amount of unstated interest is zero, because the sum of the present values of the deferred payments and the present value of any interest payments due under the contract determined using the exact method of computing interest for the short period is exactly \$60,000.00.

In section 1.483-2(e)(5), Example (1), we believe that the principal amount of the debt instrument should be specified.

E. Section 1.483-3.

We believe that the words "the present values of" should be eliminated as redundant the second time they appear in section 1.483-3(a)(2)(i).

The last sentence of section 1.483-3(b) states: "See section 1.446-2." We believe the reference should be to section 1.446-2(b)(2)(ii).

We believe that the reference in the introductory language in section 1.483-3(e) should be to section 1.446-2(g) and not to section 1.446-2(h).

The arithmetic in section 1.483-3(e), Example (3) appears to be wrong. The amount given as \$41,454.29 should be \$41,464.29. See Example (1). Even so, the sum of \$41,464.29 and \$32,791.94 is not \$74,273.23, but \$74,256.23. The problem is that \$41,464.29 and \$32,791.94 are present values calculated using a discount rate of % compounded semiannually while \$74,273.23 (more accurately \$74,273.22) is the present value of \$179,084.77, calculated using a discount rate of 9.2% compounded annually. It seems to us that, because Example (3) states that, with one exception not here relevant, the facts are the facts of Example (1), semiannual compounding should be used, because it is used in Example (1).

As in Example (3), the calculations in section 1.483-3(e), Example (4) are based on annual compounding, while Example (1) calls for semiannual compounding.

F. Section 1.483-4.

We think the words "100 percent of" in section 1.483-4(b) should be eliminated as unnecessary.

Under section 1.483-4(b)(2)(i), a special rate of interest applies to a debt instrument issued in certain sales of land between family members. One requirement is that only family members be parties to the debt instrument. The definition of family members is found in section 1.483-4(b)(2)(iii)(B). The members of an individual's family are defined to include brother and sister, spouse, ancestors and lineal descendants. Spouses of siblings, ancestors and lineal descendants are not included. Thus, a sale of land by a father to his daughter and son-in-law would seem to violate the prohibition that only family members be a party to the debt instrument. Such transactions are no doubt common and, we believe, not entered into for tax avoidance reasons. We suggest that the regulation be changed to allow a spouse to be a party to the debt instrument. We do not believe that such an interpretation would be inconsistent with the language of section 483(e)(2), which requires only that a qualified sale be to a member of an individual's family, as defined.

G. Section 1.483-5.

Present values are determined in section 1.483-5(b)(3)(i) using the test rate of interest. Since unstated interest is being determined here (rather than adequate stated interest), the imputed rate of interest (as determined pursuant to section 1.483-4) should be used rather than the test rate.

We recommend that the language in the second parenthetical in sub clause (B) of section 1.483-5(b)(3)(ii) be eliminated. It merely states the scheme of the regulations (i.e., that a contract is tested for adequate stated interest in order to determine whether it contains unstated interest).

Because the rules dealing with contingent interest and basis are complex, we think that a more extensive discussion of basis should be provided in section 1.483-5(b)(3)(iv). We suggest that the paragraph provide an example in which a purchaser initially determines his basis disregarding contingent payments and then must adjust on account of contingent payments. In addition, an example should be provided to illustrate the workings of section 1.483-5(b)(4).

The first sentence of section 1.483-5(d), Example (1), states that on March 1, 1986, A sells rental personal property to B for \$100,000. If the contract calls for a down payment of \$20,000 and a single payment of \$100,000 due in the future, as the facts of the

problem state, then the sales price should be not \$100,000, but \$120,000.

In the second paragraph of that example, we suggest that the phrase "under section 1.483-4(a)(2)" be added after the language "9.20%." That should be done to show that the interest rate here set forth is not the applicable Federal rate.

We do not believe that section 1.483-5(d), Example (3), adds much, after considering Examples (1) and (2). We suggest that one or more other examples be added, illustrating, for instance, the rules of section 1.483-5(b)(4).

13. Residential Mortgages and Other Consumer Loans.

A. General.

TRA 1984 extended the OID rules to obligations of individuals (including residential mortgages and other consumer loans) issued after March 1, 1984. This change is important not only for direct holders of obligations of natural persons, but also for owners of pass-through certificates representing beneficial interests in such obligations.

Because most consumer loans are designed to be issued at or near par, OID on such a loan generally would arise only in two ways. First, OID could arise from

payments of non-de minimis "points" or similar charges that are considered to be withheld from the proceeds of the loan and are not treated as a payment for services or of prepaid interest. Second, OID could arise if stated interest on the loan is not paid at a uniform rate or at uniform intervals, so that all or part of such stated interest is included in the stated redemption price at maturity.

While we generally agree with the treatment of obligations of individuals in the Proposed Regulations, we recommend certain modifications. First, the rules regarding when service fees, points or buy down funds result in OID need clarification. Second, it is not clear when and to what extent stated interest will be included in the stated redemption price at maturity in the case of various common types of consumer loans that do not provide for precisely uniform accruals or payments of interest. The existence of such loans demonstrates a need for the expansion of the de minimis rule proposed in part III.4.A. above. Third, the treatment of "rule of 78s" loans should be clarified. Fourth, section 483 needs to be better integrated with the market discount rules. Finally, we have some comments on the rules that defer deductions of OID on debt instruments issued by cash method obligors to finance "personal use property".

B. Service Fees, Points and Buy down Funds.

The application of the OID rules to loans to individuals is frequently complicated by the required

payment by the borrower at the time of closing of the loan of a percentage of the loan balance as a discount or prepayment of interest ("points"), or by the establishment at that time by either the borrower or a third party of one or more separate funds ("buy down funds") to be drawn upon for the payment of a portion of future interest payments on the loan. Points or buy down funds generally are used as substitutes for interest and have the effect of lowering the interest rate or current interest payments by the borrower for part or all of the term of the loan. Points are typically nonreturnable to a borrower in the event of prepayment of the loan and are in an amount equal to the present value of the foregone interest. Buy down funds may or may not be held in a separate account with the lender or be returnable upon or creditable against a prepayment, and may equal either the present value or full amount of the foregone interest. We will consider points first and then buy down funds.

(a) Points.

Points may be added by the lender to the stated principal amount of the loan (rather than being "paid" upfront by the borrower), thereby increasing the stated redemption price at maturity of the loan. This fact pattern is not addressed specifically in the Proposed Regulations but under current law would create OID (subject to the de minimis rule), which we believe is the proper result.

Alternatively, the lender may charge points but not add them to the stated principal amount because (i) at the same time that the lender disburses the full amount of loan proceeds, a "payment" of the points is made to the lender, or (ii) a "payment" of the points is deducted from those proceeds and only the net amount disbursed ("net funding"). These fact patterns are susceptible of two possible characterizations for tax purposes. The loan could be viewed as issued at par combined with a separate payment of points, or the loan could be considered to be issued at a discount. The "issue price" of the loan will depend on which view is adopted.

Section 1.1273-2(f)(2) states the general rule that cash payments from the borrower to the lender in a private lending transaction will reduce the issue price of an obligation issued for cash or publicly traded property.<sup>118</sup> Thus, in both of the situations described above, the payment of points would generally reduce the issue price and create OID.

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<sup>118</sup> The Proposed Regulations state that a payment of points, by the buyer-borrower to the seller-lender in a transaction subject to section 1274 will be considered to reduce the stated principal amount of the debt instrument evidencing the loan. We do not understand this approach. It is inconsistent with the fact that the full principal amount must be paid. We believe that it would be more appropriate to treat the cash payment as additional consideration given to the seller for the property separate and apart from the debt instrument. If it is desired not the property because to increase the purchase price of the payment of points, then the issue price of the debt instrument could be reduced by the amount of points. In that event, the debt instrument would be considered to have an issue price equal to the lesser of (i) the principal amount less the amount of points or (ii) the imputed principal amount determined under section 1274(b).

The Proposed Regulations provide three exceptions to this general rule. First, payments for services provided by the lender, such as commitment fees or loan processing costs, do not reduce the issue price of a debt instrument. Section 1.1273-2(f)(2). Instead, they are treated under principles of tax law outside the context of OID (generally as service income to the lender and as a non-deductible capital expenditure amortizable over the life of the loan by the borrower). We believe that this treatment is appropriate.

Second, points paid on a loan incurred in connection with the purchase or improvement of, and secured by, the borrower's principal residence, which are deductible under section 461(g)(2), will not be subject to the rule that the issue price be reduced. Section 1.1273-2(f)(1).<sup>119</sup>

This exception apparently is predicated on a matching concept that requires the lender to include the points in income currently as a prepayment of interest if the borrower receives a current deduction. While we agree with the rationale for the exception, its application in practice will be uncertain because not all transfers of cash will constitute "payment" for purposes of section

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<sup>119</sup> Conversely, points paid in connection with a refinancing of a principal residence or the financing of a second residence, or points exceeding the amount generally charged in the area in which the indebtedness is incurred, will not be deductible by the borrower under section 461(g)(2) and will therefore reduce the issue price and may result in OID.

461 (g)(2).<sup>120</sup> The position of the IRS appears to be that if points are added to the principal amount of a loan they are not considered paid, but if the points are withheld from the loan proceeds and the documents are ambiguous concerning the parties' intention with regard to current payment or discount treatment, then the points will be considered paid.<sup>121</sup> To resolve the administrative difficulties that can arise from the lack of a clear rule, we recommend that regulations be promulgated under section 461(g)(2) or a revenue ruling issued that would adopt the apparent position of the IRS described above and thus remove any tracing requirement. Under a third exception, if the total amount of OID on the obligation, including payments that would otherwise reduce the issue price, is less than the de minimis amount determined under the rules of section 1.1273-1(a)(3), then those payments will be accounted for by the lender under principles of law outside of sections 1272 and 1273, although the loan would still be considered to have OID from the borrower's perspective.

(b) Buy down Funds.

Another case to consider is when the lender requires the borrower or a third party to establish a buy down fund which will be used to supplement current

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<sup>120</sup> Compare Battlestein v. Commissioner, 631 F.2d 1182 (5th Cir. 1980) (interest check sent to lender followed by check for same amount sent to borrower by lender in exchange for note held not to constitute payment), With Burck v. Commissioner, 63 T.C. 556 (1975), aff'd, 553 F.2d 768 (2d Cir. 1976) (interest payment from checking account in which loan proceeds were deposited held to constitute payment).

interest payments by the borrower for all or part of the term of the loan. In general, the OID consequences of the buy down fund will not depend on whether contributions to the fund are made by the borrower or a third party.<sup>122</sup>

We agree that the issue price should be reduced under section 1.1273-2(f) by the amount of a buy down fund (regardless of the source of the fund) in those cases where the terms of the fund are such that the fund constitutes a true payment to the lender. However, we believe that, under the terms of the mortgage note and the buy down account, such funds often do not become the property of the lender (and are therefore not "paid" to the lender) until such time as they are drawn upon to pay stated interest, or to pay loan principal in the event of a full prepayment or a default. We recommend that the final regulations confirm that the establishment of a buy down fund will be treated as a payment only if the fund is considered to become the property of the lender. We also recommend adoption of a safe-harbor rule. Under this rule, a buy down fund would be treated as property of the borrower (and therefore not a payment to the lender) if (i) a separate account (either a regular deposit or some type of custodial arrangement, including a deposit with the lender if it is regularly in the business of accepting deposits, but not necessarily a trust account or a segregated account for each borrower) is established

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<sup>121</sup> See, e.g., TAM 8631007 (April 18, 1986).

<sup>122</sup> Under the Proposed Regulations, payments from a third party to the lender are treated in appropriate circumstances as made from the third party to the borrower followed by a payment in the same amount from the borrower to the lender. See section 1.1273-2(f)(5), Example 6.

for the buy down funds, (ii) the mortgage note obligates the borrower to pay the full fixed or variable rate of interest plus principal, but the buy down account permits a reduction in the borrower's out-of-pocket monthly payment for part or all of the loan term and the balance of the buy down account is returnable to the borrower or creditable against the unpaid balance of the loan upon a prepayment, (iii) the borrower is taxable on any interest credited to the buy down account, and the lender reports such interest to the IRS and the borrower accordingly under applicable information reporting rules, and (iv) the buy down account is assignable upon an assumption of the mortgage loan in connection with the sale of the real property securing the loan in the event such an assumption is allowed, or is otherwise credited to the borrower.

C. Examples of Specific Types of Residential Mortgages.

This portion of the report describes various types of typical consumer loans that do not provide for precisely uniform accruals or payments of interest. These loans raise questions regarding when and in what amounts stated interest will be included in the stated redemption price at maturity. Their existence also demonstrates a need for modification of the de minimis rule for situations where minor deviations in uniformity result in disproportionately large amounts of stated interest being recharacterized as OID.

The loans discussed below provide interest that is based, at least in some periods, on a variable rate, therefore, the general discussion of variable rate loans in part III.9. above is also relevant here.

(a) Payment Capped Variable Rate Loans.

Interest on certain variable rate loans is computed according to an index, but the terms of the loan may limit the amount by which the periodic installment payment may increase on an annual (or some other) basis.<sup>123</sup> A similar feature on some loans would allow the variable interest rate to be adjusted more frequently than the payment. Interest may accrue on either of these types of loans in excess of the amount of the capped payment, in which case the excess would be added to the principal balance of the loan.

Under section 1.1275-5(d)(1), the "excess of the amount of interest that actually accrues under the terms of the debt instrument during an accrual period over any qualified periodic interest" constitutes OID for the applicable period. Thus, the interest that accrues but is not paid on payment capped loans would be taxable as it accrues. This is appropriate. However, we are uncertain as to how to determine the amount of interest that is qualified periodic interest.

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<sup>123</sup> For purposes of this discussion of payment capped loans, it is assumed that such variable rate interest is Qualified Indexed Interest. As noted in part III.9 above, the regulations under section 1.1275-5 should state expressly that those regulations will apply notwithstanding the existence of rate and/or payment caps.

Under section 1.1273-1(b)(1)(ii)(A), interest that represents the product of the outstanding principal balance of a debt instrument and a variable rate tied to a single objective index of market interest rates governed by section 1.1275-5, and that is actually and unconditionally payable monthly, constitutes qualified periodic interest. It is not clear whether the existence of a payment cap would prevent variable rate interest that would otherwise fall within this definition from being qualified periodic interest. We recommend that all stated interest on a variable rate loan be considered qualified periodic interest other than such interest that (i) because of a payment cap or other factors is not actually payable before the end of the accrual period in which it accrues under the terms of the loan, or (ii) would not be qualified periodic interest if the index on which the interest is based had a value over the life of the loan equal to its value on the issue date (or earlier contract date). This proposed rule is supported by section 1.1273-1(b)(1)(ii)(B), which states that interest on a loan that provides for interest at one fixed rate followed by interest at a variable rate will be qualified periodic interest if the amount that would be the variable rate on the issue date (or earlier contract date) equals the initial fixed rate.<sup>124</sup>

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<sup>124</sup> Example (2) at section 1.1275-5(d)(5) concludes that none of the interest on a \$100,000 loan is qualified period interest where the loan provides for (i) fixed semiannual payments of \$9,000 (or the outstanding loan balance if less), (ii) interest that accrues at a variable rate based on current values of an objective index, and (iii) a final payment of principal and accrued interest after 15 years. Apparently, the loan was written so that the accrued interest was always added to the loan balance and the \$9,000 payments reduced the loan  
(footnote continued)

It should also be made clear that a variable rate loan that would not have a more than de minimis amount of OID based on the value of the objective interest index on the issue date (or earlier contract date) will not be considered to have OID for purposes of the leg ending and information reporting rules in section 1.1275-3.

(b) Loans With a Variable Rate Convertible to a Fixed Rate.

Variable rate mortgage loans may provide for a variable rate that is convertible, on any date or after a specified date, to a fixed rate equal to or based on the last variable rate at the option of the mortgagor. Such a loan does not appear to meet the definition of a debt instrument that states interest based on current values of an objective index, since it does not do so for the entire term of the loan. Section 1.1275-5(d)(4) provides a catch-all rule to prevent the frontloading or back loading of interest on a loan with a fixed rate in some accrual periods and a variable rate in other accrual periods, arguably covering the above case. Also, section 1.1273-1(b)(ii)(B) allows a loan with an initial fixed rate followed by a variable rate that is initially the same rate as the fixed rate to meet the definition of qualified periodic interest.

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balance but were not broken down between interest and principal. By contrast, interest on the payment capped loans described in the text would be paid currently as interest unless the cap applies.

Because conversion of the variable rate loan to a fixed rate loan is optional with the mortgagor and holds little apparent potential for deferring income, we recommend that section 1.1275-5 be clarified to provide that neither the existence nor the exercise of such a conversion option will prevent the normal rules for variable rate loans in section 1.1275-5(d)(1)-(3) from applying to the loan. We further recommend that section 1.1273-1(b)(ii) be expanded to include interest on such a loan within the definition of qualified periodic interest.

(c) Incentive Rate Mortgages.

It is not uncommon for variable rate mortgages to provide for an incentive or "teaser" rate for an initial period, usually one year, with the rate after that period being stepped up to the fully indexed rate. The incentive rate is generally a fixed rate, but could be a variable rate determined as a lesser margin over the same objective index that will be used after the incentive period, e.g., 50 basis points over the objective index, stepping up to 250 basis points over the index after the incentive period. Such an incentive rate may or may not be accompanied by the payment of points (which, in turn, may or may not be de minimis standing alone).

Although section 1.1275-5(d)(4) specifically addresses this type of loan, the section merely states that any OID should be reallocated "in a manner

consistent with the rules of section 1272 and 1275." Presumably, what is required is to (i) construct a hypothetical fixed rate loan by freezing the rate index based on its value on the issue date or contract date, (ii) apply the OID rules to that loan, and (iii) adjust each month's interest income for the difference between the assumed rate and the actual rate. In applying the OID rules to the hypothetical loan, the first year's incentive rate would be a qualified periodic interest payment, the first year's OID would equal the adjusted issue price for each month times the yield of the hypothetical loan (less applicable principal payments), and each monthly interest payment after the first year would be comprised in part of qualified periodic interest and in part of OID (reduced by some amount on account of the OID allocated to the first year).

Such a computation seems unnecessarily complex where interest would be qualified periodic interest disregarding the rate of interest in the first 12 months. This is especially true if the borrower pays points on origination; taking account of such points as a prepayment of all or part of the first year's "missing" interest may well eliminate all or most of the apparent rate reduction.

Whether or not points are paid, we believe that the possible application of the OID rules to incentive rate loans illustrates the need for the alternative de minimis rule described in part III.4.A. above. As applied to first year incentive rate loans, if the first year's

rate is at least 50% of the non-incentive rate determined based on the initial value of the objective interest index, then there would be a deferral of no more than six months' worth of interest as a result of the incentive feature. Accordingly, under the modified rule, such a loan would have de minimis OID.

D. Deferred Deductions When Financing Personal Use Property.

Under section 1275(b), if an individual (or other cash method taxpayer) incurs debt in connection with the acquisition or carrying of personal use property, then (i) sections 483 and 1274 do not apply and (ii) in the case of debt instruments issued for cash or publicly traded property, any OID on the instrument is not deductible until it is paid. These rules apparently are intended to prevent consumers from benefiting from the extension of the OID rules to obligations of individuals. The determination of whether property is personal use property is made as of the time of issuance of the debt instrument. Personal use property is defined as any property substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in section 212. Consequently, home mortgages as well as other types of consumer loans are affected by this provision.<sup>125</sup>

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<sup>125</sup> The pertinent legislative history indicates that Congress intended the personal use property exception to apply to the purchaser of a home who intends to use part of the home as an  
(footnote continued)

In the case of a home mortgage that provides for interest at an incentive rate for one year and interest at a higher rate thereafter, the later payments of interest would not be qualified periodic interest to the extent they exceeded the incentive rate. Accordingly, a significant portion of the stated interest on such a loan would be OID and therefore potentially subject to the rule that defers deductions until the OID is paid. Questions have been raised as to whether this rule might result in a significant deferral of interest deductions.<sup>126</sup> The Proposed Regulations make it clear, however, that the effect of the rule is to prevent consumers from taking advantage of an acceleration of interest deductions under the OID rules and not to place them in a worse position than if those rules had not been extended to consumer loans. We agree that this is an appropriate result.

Under the Proposed Regulations, stated interest that is treated as OID (because such stated interest is not qualified periodic interest) is treated as paid solely by reference to the terms of the debt instrument (section 1.1275-2(f)(2)(ii)). Thus, in the case of the loan described above, the portion of the stated interest that is OID would be deductible when the stated interest

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office. S. Rep. 98-169, 98th Cong. 2d Sess, 258 (1984). The definition of "personal use property" in section 1.1275-2(f)(3) should reflect that statement.

<sup>126</sup> See letter dated February 27, 1985 from James M. Peaslee to Mikel Rollyson, reprinted in Tax Notes, March 11, 1985 at 1035.

is paid, as if the OID rules did not apply.<sup>127</sup> Second, de minimis discount represented by the excess of the principal amount of a loan over its issue price may be deducted according to a straight-line formula under section 1.163-7(d). See section 1.1275-2(f)(4), Example (2). While this method of OID accrual can be questioned on economic grounds, the simplicity of a straight-line method for what is concededly a de minimis amount should prevail in the context of a consumer loan. Finally, OID not covered by the foregoing rules is considered to be paid with amounts included in the stated redemption price at maturity to the extent such OID has accrued at the time of the payment and not previously been paid. See section 1.1272-1(e)(2)(ii), last sentence.<sup>128</sup> Some modification in the text of this rule may be appropriate to coordinate it with section 1.1275-2(f)(2)(ii).

#### E. Rule of 78s Loans.

The Proposed Regulations have created considerable uncertainty as to the tax status of loans that allocate payments between principal and interest (or calculate the rebate of unearned finance charges in the event of a prepayment in full) under the "rule of 78s".

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<sup>127</sup> In the case of a loan that provides for stated interest at a rate that declines over time, this rule could be read to permit the deduction of prepaid interest. Presumably, this was not intended. One example of such a loan, which is discussed below, would be a rule of 78's loan.

<sup>128</sup> We do not object to a "discount-first" approach in the context of section 1275(b) as a means of permitting as rapid a catch-up as possible of the deductions that would have been allowed if OID was deductible as it accrues. However, we do object to the approach in the context of applying the market discount rules for reasons discussed in part III.6.

The uncertainty arises primarily from an unacknowledged conflict between the Proposed Regulations and prior rulings and revenue procedures. A question also exists as to whether rule of 78s loans that are issued for cash are governed by section 1272 or section 446.

(a) Prior Administrative Practice.

In Revenue Ruling 83-84, 1983-1 C.B. 97, the IRS ruled that interest allocations under the rule of 78s lacked economic substance and that no deduction for interest would be allowed for any year in excess of the amount of interest that economically accrues. In Revenue Procedure 83-40, 1983-1 C.B. 774, the IRS created an exception to this holding, on grounds of administrative convenience, that permits either borrowers or lenders to continue to use the rule of 78s for 60-month or shorter consumer loans that are written based on the rule of 78s, and have level payments due at regular intervals at least annually and no balloon payments, i.e., typical rule of 78s consumer installment loans, such as automobile loans. Revenue Procedure 84-30, 1984-1 C.B. 482, provides an expeditious procedure for a taxpayer that wishes to change its accounting method from the rule of 78's to an economic accrual method with respect to consumer loans that fall under Revenue Procedure 83-40. In Revenue Ruling 86-42, I.R.B. 1986-13, 33, the IRS reaffirmed the applicability of the rule of 78s exception in Revenue Procedure 83-40, and gave guidance as to the treatment of

the prepayment penalty that results from use of the rule of 78s.<sup>129</sup>

(b) Section 1272.

Because of the extension of section 1272 to consumer loans, it is necessary to consider how that section would apply to rule of 78s loans. Because consumer loans ordinarily involve small amounts (payments less than \$250,000), section 1274 would not generally apply to such a loan that represents seller financing. On the other hand, section 1272 would apply to consumer loans that were issued for cash because there is no small loan exception in that section (except for loans between individuals).

Section 1.1273-1(b)(1)(ii) generally defines a qualified periodic interest payment with respect to a fixed rate loan as any one of a series of payments equal to the product of the outstanding principal balance and a single fixed rate of interest that is payable at fixed intervals over the entire term of the loan. In the case of a rule of 78s loan, stated interest payments represent a declining percentage of the principal balance over the

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<sup>129</sup> Revenue Ruling 86-42 holds that a prepayment penalty is interest. That holding is difficult to reconcile with Revenue Ruling 72-587, 1972-2 C.B. 74 (call premium is capital gain), modified on other grounds by Revenue Ruling 80-143, 1980-1 C.B. 19. The distinction appears to be based on the fact that section 1271(a)(1) treats the retirement of a debt instrument of a legal entity as a sale or exchange, but does not apply to individuals, although it is not clear why this should affect whether a premium that is ordinary income is considered to be interest or something else. Clarification of this point would be helpful. See GCM 39543 (August 8, 1986) for a discussion of the historical treatment of call premiums.

life of the loan. Thus, it would appear that interest payable on a payment date prior to the last payment date would be qualified periodic interest only to the extent it does not exceed an amount equal to the product of the unpaid principal balance of the loan immediately prior to such payment date (computed under the rule of 78s method) and a fraction, the numerator of which is the amount of interest included in the last payment on the loan and the denominator of which is the amount of principal included in that last payment (in each case, computed under the rule of 78s method). Thus, unless the resulting amount of OID is de minimis under the existing de minimis rule, which is not likely to be the case, the lender would be required to report interest income under section 1272 based on the yield to maturity of the loan.<sup>130</sup>

This result would be inconsistent with the revenue rulings and revenue procedures referred to above, which give the lender the right to report income under a rule of 78s or economic method in the case of consumer loans.

Whether or not OID exceeds a de minimis amount, the borrower would also generally report interest deductions based on the yield to maturity of the loan. However, if the borrower has borrowed to purchase personal use property, then the borrower would be allowed

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<sup>130</sup> Appendix B shows how the existing de minimis rule would apply to hypothetical 12-month and 48-month rule of 78s loans. In each example, the amount of OID exceeds a de minimis amount. Section 1272 would not apply to the 12-month loan because it does not have a term greater than one year, but section 1281 may apply.

deductions for OID under section 1275(b) only when the OID is paid. Under section 1.1275-2(f)(2)(ii), OID that results from the inclusion of stated interest in the stated redemption price maturity is considered to be paid solely by reference to the terms of the debt instrument. This could mean that such a borrower can deduct interest under the rule of 78s method, although that would be a somewhat surprising result given the purpose of section 1275(b). On the other hand, applying sections 163(e) and 1272 to require deductions to be taken on an economic basis would be inconsistent with Revenue Procedure 83-40.

(c) Section 446.

Where a loan is issued for cash, and section 1272 applies as discussed above, then section 1.446-2 would not apply because of the priority rule in section 1.446-2(a)(1)(i). On the other hand, if a rule of 78s loan is issued in exchange for property and section 1274 does not apply, then section 1.446-2 would apply.

Sections 1.446-2(d) and (e) provide rules for the situation where the parties allocate payments between principal and interest on an obligation on a basis other than that of economic accrual (i.e., other than where all payments are, first, interest to the extent of interest then accrued on outstanding principal at the yield to maturity and, second, payments of principal). In that situation, the regulations provide, in effect, that, as long as the aggregate stated interest payable on or before any point in time is at least equal to the aggregate interest (including imputed interest, if any,

arising under section 483) that would accrue economically on or before that point in time, (a) the parties' allocation of payments between principal and interest is respected, (b) any payments allocated by the parties to interest in excess of interest accrued on an economic basis is prepaid interest, (c) the lender must include prepaid interest in income when received regardless of his method of accounting, and (d) the borrower can deduct the prepaid interest only when it economically accrues. These rules are illustrated by section 1.446-2(g), Examples (2), (4) and (8). Example (8) applies the rules in the context of a loan allocating payments between principal and interest on the basis of the rule of 78s. Under section 1.446-2(h), section 1.446-2 generally applies to transactions occurring after May 8, 1986.

The application of the regulation to certain rule of 78s loans is inconsistent with the published authority described above. Rule (d) above conflicts with Revenue Procedure 83-40. Rule (c) above is inconsistent with Revenue Procedure 84-30. Rules (c) and (d) are both also inconsistent with Revenue Ruling 86-42. While Revenue Ruling 86-42 involves a loan made in 1981, prior to the proposed effective date for the new regulations, it provides no hint that it might not be applicable for newly made loans.

We believe that sections 1.446-2(d) and (e) go too far in requiring amounts greater than economic interest to be reported as income if the parties have provided for the total interest on a fully amortizing installment obligation to be computed based on a single,

fixed rate. In general, we believe that the approach of Revenue Ruling 83-84 in disallowing use of the rule of 78s for both borrowers and lenders to be correct, and we would be in agreement if the administrative exception in Revenue Procedure 83-40 were revoked. This would also conform the treatment of loans issued in exchange for property to the treatment of loans issued for cash that are subject to section 1272.

(d) Recommendations.

To the extent sections 1272 and 163(e), or sections 1.446-2(d) and (e) in their final form, are inconsistent with the revenue rulings and revenue procedure described above, those rulings and revenue procedure should be revoked prospectively, to avoid the current uncertainty arising from the conflicting authorities. In addition, if sections 1.446-2(d) and (e) are retained in substantially their present form, contrary to our recommendation above, then section 1.446-2(d) should be modified by adding a new paragraph (4) providing that the parties will be deemed to have allocated payments on an obligation between principal and interest only if the obligation expressly states how the allocation is to be made or a schedule of principal and interest payments is provided, and that the method used to rebate the unearned interest portion of a total contract price upon a full prepayment does not constitute such an express allocation.

F. Integration of Section 483 and Market  
Discount Rules.

Section 483 may be applicable to lenders with some frequency in the case of consumer loans. Recent automobile loans with incentive rates of 2.9% and even lower are examples. An issue arises when such loans are sold, either as whole loans or in the form of pass-through certificates, as to whether purchasers of such loans continue to report imputed interest under section 483, or instead the imputed interest is converted into market discount (since the loans would generally be sold at a discount to take account of the artificially low stated interest rate).

We believe that section 483 should not apply to a transferee of a loan subject to section 483 where the transferee is unrelated to the seller and purchases the loan for cash, at least where the loan was originated after July 18, 1984. The only possible effect of applying section 483 would be to transform some portion of any discount at which the loan is purchased into interest (but, consistent with section 483 generally, not to advance the timing of reporting of that discount). However, in the case of loans originated after July 18, 1984, that same result would be accomplished already for most tax purposes under section 1276. Thus, the practical consequences of extending section 483 to such a buyer would be insignificant.<sup>131</sup>

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<sup>131</sup> While section 1276 does not apply to loans having an original term to maturity of one year or less, the same is true of  
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In the event that our recommendation is not accepted and section 483 is applied to a cash purchaser of a loan that was subject to section 483 in the hands of the seller, it will be necessary to coordinate section 483 with the market discount rules. In particular, market discount is defined in section 1278(a)(2) as the excess (if any) of the stated redemption price at maturity of an obligation over its basis immediately after its acquisition by the taxpayer. Where an obligation has OID, the revised issue price is substituted under section 1278(a)(2)(B) for the stated redemption price at maturity. Obligations subject to section 483 are not considered to have OID so that this rule would not apply to such obligations; nonetheless, amounts treated as interest under section 483 should be excluded from the stated redemption price at maturity of an obligation for purposes of measuring market discount. This result may follow from the general rule of section 1.483-

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section 483. Our recommendation is subject to one possible qualification. In the case of a loan that is subject to section 483 and provides for installment payments of principal, we would not object to a rule that allocates principal payments first to accrued unstated interest calculated based on the applicable Federal rate that originally applied to the loan. On the other hand, we have originally applied to the loan. On the other hand, we have recommended in part III.6. above that the "discount-first" approach to the taxation of market discount on installment obligations adopted under TRA 1986 be reconsidered. If our recommendation regarding market discount is followed, then, it might be necessary to extend section 483 to a cash purchaser of an installment loan that has unstated interest.

1(a)(2)(ii) treating unstated interest as interest for tax purposes. Finally, if section 483 applies to a cash purchaser of a loan, rules would be required to account for any difference between the purchase price and the basis the Loan would have at the time of the purchase in the hands of the original holder.

G. Information Reporting Requirements.

A number of special problems are encountered in applying the legending and information reporting requirements of section 1.1275-3 to pass-through certificates representing interests in consumer loans. These are discussed in part III.7. above.

14. Convertible and Exchangeable Instruments.

Convertible and convertible-like instruments (hereinafter collectively referred to as "Convertibles") raise a number of difficult questions under the OID rules, as well as other Code provisions. Some of these issues are dealt with in the Proposed Regulations, while others are not addressed. Discussed below are the various types of Convertibles, the principal tax issues raised by Convertibles, the treatment of Convertibles under existing law and the Proposed Regulations, and our recommendations regarding the proper tax treatment of Convertibles.

A. Types of Convertibles.

For purposes of this discussion, a Convertible is considered to be a debt instrument that carries a non-separable right to acquire an equity security (or to receive payments linked to the value of an equity security) upon presentment of the debt instrument. Thus, a Convertible is similar to a straight debt obligation coupled with a detachable warrant in that the purchaser is assured of a fixed income stream, but also may benefit in the event the underlying equity security appreciates. A Convertible is different from such an investment unit, however, in that the debt and warrant elements are inseparable. The value of the warrant cannot be realized without exchanging the debt, and the consideration initially paid is not as readily traced to the debt and warrant elements.

There are several different types of Convertibles. A "True Convertible" is the garden variety corporate debt instrument that is convertible, at the option of the holder by the issuing corporation, into stock of that corporation, generally at a price that reflects an initial premium over the market price of the stock. A "Portfolio Convertible" is a debt instrument that is convertible, at the option of the holder by the issuer, into stock of a third party, which may or may not be affiliated with the issuer. An "Exchangeable" is a debt instrument that gives the holder a right to present the instrument to a corporation that is not the issuer of the debt instrument (but generally is an affiliate of such issuer) and receive in exchange stock of that corporation. After presentation, the Exchangeable becomes

a straight debt obligation in the hands of that corporation. Finally, an "Equity-Indexed Obligation" is debt that provides for additional payments, generally at maturity, measured by appreciation in the value of one or more underlying equity securities.

#### B. Tax Issues.

The principal conceptual issue that arises in determining the proper tax treatment of Convertibles is whether and in what circumstances the bifurcated nature of a Convertible should be recognized. This question initially arises upon issuance in determining whether the consideration paid for the Convertible should be allocated in part to the warrant element, thereby creating the potential for OID. A second major question is raised in the event the holder receives value, whether in the form of stock, indexed payments, or proceeds of a cash redemption, that is attributable to the warrant element of the Convertible. The critical issue here is whether payments or other property received in respect of such warrant element should be treated as additional interest or bond redemption premium to the issuer or holder, or whether they should instead be viewed as consideration received upon exercise of (or in a closing transaction with respect to) the warrant element of the Convertible.

#### C. Existing Law.

Under the Treasury regulations promulgated under section 1232, no part of the issue price of a Convertible was attributed to the warrant element thereof. Thus, a Convertible did not generate OID unless the amount received upon issuance was less than its stated redemption price at maturity. See section 1.1232-3(b)(2). See also, e.g., Chock Full O'Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971). While there was some argument that this regulation did not apply where the instrument was an Exchangeable rather than a True Convertible, there is substantial judicial support for the contrary view. See National Can Corp. v. United States, 520 F. Supp. 567 (N.D. III. 1981) aff'd on other issues, 687 F.2d 1107 (7th Cir. 1982); Honeywell Inc. v. Comm., 87 TC No. 37 (1986).<sup>132</sup>

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<sup>132</sup> It has been argued that Revenue Ruling 69-265, 1969-1 C.B. 109, supports treatment of an Exchangeable as a debt-warrant unit for purposes of the OID rules. We do not agree. Revenue Ruling 69-265 considers whether the acquisition by a corporation ("S2") of the assets of another corporation ("T") in exchange for voting stock of the direct parent of S2 ("S1") qualifies as a "c" reorganization. The S1 stock was exchangeable at the holder's option for common stock of the direct parent of S1 ("P"). The ruling holds that this exchange right constituted boot (so that the S1 stock together with the exchange right was not "solely voting stock" of S1) where the right was exercisable against P but not where it was exercisable against S1. Whether or not this distinction makes sense as a tax policy matter, it is not surprising given the existing definition of a "C" reorganization. That definition allows non recognition treatment only where shareholders of an acquired corporation maintain a continuing investment in that corporation by receiving solely voting stock of the acquiring corporation or its direct parent. In the ruling, P was the grandparent of the corporation acquiring the assets of T. Therefore, the granting to T stockholders of a direct claim against P that was not subject to the risks of the business of S1 or S2 was thought to be inconsistent with the solely-for-voting stock requirement. On the other hand, an exchange right against S1 would be subject to the prior claims of S1's creditors to the same extent as any other equity investment in

(Footnote continued)

The law is somewhat more muddled as regards the characterization of payments received in respect of the warrant element of a Convertible. In the case of a True Convertible, the conversion generates no gain or loss and no interest income or expense.<sup>133</sup> In the case of a Portfolio Convertible, it is generally assumed that the holder recognizes gain or loss measured by the difference between the holder's basis in the Portfolio Convertible and the fair market value of the stock received upon conversion. It is also generally assumed that the corporate issuer recognizes gain or loss measured by the difference between its basis in the portfolio security exchanged and the revised issue price of the Portfolio Convertible (except possibly where the portfolio stock is stock of an affiliated corporation). While the authorities regarding Exchangeables are few, the tax consequences of the exchange for the holder generally are viewed as comparable to those attending the exchange of a Portfolio Convertible. The issuer of an exchange right relating to the issuer's own stock would have an uphill

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(Footnote 133 continued from previous page)

S1. No similar continuity issue exists in applying the OID rules. The Tax Section has previously taken the position that Exchangeables should not be treated differently from Convertibles. See Report on International Finance Subsidiaries, 28 Tax L. Rev. 439, 490-91 (1973).

<sup>133</sup> Non recognition treatment may be justified on the ground that the conversion is a "recapitalization" to which section 354 applies or that it is analogous to the purchase of the underlying stock through exercise of an option. See Fleisher & Cary, The Taxation of Convertible Bonds and Stock, 74 Harvard Law Review 473 (1961). The most recent IRS statement of the non recognition rule for True Convertibles, Revenue Ruling 72-265, 1972-1 C.B. 222, does not choose between these theories. It may be noted that the option analysis would not explain the different treatment that is generally assumed of True Convertibles, on the one hand, and Portfolio Convertibles and Exchangeables, on the other hand.

battle obtaining any deduction for the value of the exchange right in view of National Can and Honeywell decisions noted above. Finally, there is little authority regarding Equity-Indexed Obligations.

Section 249 deals with the issuer's repurchase at a premium of certain types of convertible bonds. Under section 249, the issuer is denied a deduction for bond repurchase premium on an obligation convertible into stock of the issuer (or of an entity controlled by or controlling the issuer under the section 368(c) definition of control) to the extent that the repurchase price exceeds an amount equal to the revised issue price plus a normal call premium on a comparable straight bond. Section 249 does not address the tax treatment of the holder. Also, many types of Convertibles are not covered by section 249.

#### D. Proposed Regulations.

Section 1.1273-2(e) provides that "the issue price of a debt instrument which is convertible into stock or another debt instrument of the issuer shall include any amount paid with respect to the conversion privilege." This is somewhat narrower than section 1.1232-3(b)(2), which refers to "an obligation which is convertible into stock or another obligation". Section 1.1273-2(e) literally applies only to True Convertibles and not to Portfolio Convertibles or Exchangeables. The preamble to the Proposed Regulations invites comments on "[w]hether a portion of the issue price of a debt

instrument providing for a conversion feature should properly be allocated to that conversion feature in a manner similar to the allocation of issue price for investment units under section 1273(c)(2).” Finally, section 1.1275-4 contains rules dealing with contingent payments (see part III.8. above). It has been suggested that those rules may apply to treat value received in respect of the warrant element of a True Convertible ,as additional interest, particularly in light of the fact that the definition of “debt instrument” in section 1.1275-1(b) includes a debt instrument calling for payments in the form of stock. In our view, that is not a proper reading of the Proposed Regulations.

#### E. Discussion and Recommendations.

While Convertibles are economically similar in some respects to debt-warrant units, they also may be viewed as merely one of many possible types of contingent debt instruments. Therefore, in fashioning rules for Convertibles it is important to keep in mind not only the treatment of debt-warrant units but also the contingent payment rules in section 1.1275-4. Those rules treat a contingent payment obligation as a single security. Thus, no separate allocation is made to the right to receive contingent payments and all income attributable to those payments is treated as interest.<sup>134</sup>

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<sup>134</sup> As discussed in part III.8.C. above, the contingent payment rules are properly applied only to debt instruments that are recognized to be indebtedness under general tax law principles. The discussion of Convertibles herein is limited to **Convertibles** that meet this standard. Thus, the discussion (footnote continued)

Convertibles could potentially be distinguished from other contingent payment obligations on any of three grounds: (i) payment upon exercise of the conversion or exchange right is made in kind rather than in cash, (ii) exercise of that right is discretionary with the holder, and (iii) in the case of a True Convertible, the conversion is a non recognition transaction. While we believe that the last item should be recognized to be a true point of distinction, the other two are not. The medium of payment should be irrelevant to the tax treatment of the issuer and holder. Furthermore, because it is highly likely that an option to buy stock will be exercised before expiration if the stock has a market value greater than the option price, and will not be exercised if the market value is below that price, the importance of the element of discretion is questionable.

In deciding whether Convertibles should be treated like debt-warrant units or rather like other contingent payment obligations, we believe that the line should be drawn based on whether the conversion or exchange right is separately assignable. Under that standard, Convertibles would be grouped with other contingent payment obligations and not with debt-warrant units.

Where a warrant and a debt instrument are separately assignable and not economically

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(footnote continued from previous page)

may not apply where, for example, the value of the "debt" features of a particular Convertible is unusually low by comparison with the value of its "equity" features.

interdependent, it is inevitable that the tax law will treat them as two distinct securities. On the other hand, if the debt and equity features of a debt instrument cannot be separately assigned, they should not be treated as if they were in fact separate items of property. It may be difficult to properly value those features in isolation if they were never intended to stand alone. More importantly, if one component cannot be held without the other, it makes little economic sense to require a holder to report income with respect to the debt component without taking account of possible losses attributable to the equity component which would be the consequence of applying the investment unit rules. The discussion in part III.8.C.(c)(ii)(c) above of the separation-of-noncontingent-payments approach to the treatment of contingent payment obligations is relevant here.

While it is important that the treatment of Convertibles be reconcilable with the rules for debt-warrant units and contingent payment obligations, account should also be taken of the put/call rule at section 1.1272-1(f)(4) (discussed in part III.3.C.). In our view, the difference between an option subject to the put/call rule and the option feature of a Convertible is simply that in the former but not the latter case, the amount to be received upon exercise of the option is fixed in advance.

In light of the foregoing, we recommend the adoption of the following rules:

(1) An allocation of issue price would be made between the "warrant" and "debt" elements of a security (or group of securities issued at one time) if, and only if, those elements are separately assignable without significant impairment of value. Thus, no allocation would be made to the option features of any form of Convertible (including an Exchangeable). The issue price of an investment unit consisting of a bond and a separately assignable warrant that is exercisable for cash would continue to be allocated between the two components. However, an investment unit consisting of a bond and a warrant that can be exercised only through delivery of the bond, or, at the holder's option, through delivery of the bond or payment of an amount of cash that is expected under almost all circumstances to exceed the fair market value of the bond, would be treated in the same manner as a Convertible if it is concluded that the warrant could not be separated from the bond without significant impairment of value. This would generally be the case if bonds that could be used to exercise a warrant are not expected to be available for separate purchase by the holder of a warrant without a bond at a price that reflects only the debt characteristics of the bond (i.e., a price that is not marked up so as to absorb much of the value of the warrant).

(2) If the stated rate of interest on a Convertible (other than a True Convertible, or a

Portfolio Convertible or Exchangeable that receives similar treatment to a True Convertible under (4) below is below the assumed rate, then interest would accrue at the assumed rate under the general rules for contingent payment obligations recommended in part III.8.C. above.<sup>135</sup> Otherwise, no amount would be included in income in respect of the option feature of a Convertible until the amount attributable to that feature becomes "fixed" (which would occur only on exercise of the option).

(3) Subject to the next paragraph, exchange of a Convertible for stock would be treated in the same manner as if a cash payment had been made by the issuer to the holder equal to the fair market value of such stock. Income realized by the holder would be treated as interest and would be deductible by the issuer. The issuer would be treated as selling such stock to the holder at a price equal to such fair market value and would recognize gain or loss (which would be capital or ordinary depending on the circumstances) in the same manner as if the stock had been sold for cash to the holder.

(4) The only exception to the rule in (3) above

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We do not recommend that interest accrue at the assumed rate if it exceeds the stated rate of interest in the case of True Convertibles and other similarly treated securities because that result would be inconsistent with the established policy of not treating any part of the conversion or exchange premium with respect to such securities as deductible interest.

is that the exchange of a True convertible for stock of the issuer would continue to be nontaxable to the holder and the issuer would have no deduction under section 1032. An exchange of a debt instrument which is a Portfolio Convertible or Exchangeable for stock of a corporation under common control with the issuer would receive similar treatment in circumstances where section 249 would deny the issuer a deduction for the excess of the value of the stock over the revised issue price the debt instrument.<sup>136</sup> Such exchange would be taxable to the holder but gain resulting from the exchange that is attributable to the conversion feature would not be interest and in most cases would be capital gain.

(5) An Equity Indexed Obligation should be treated in the same manner as if (i) the instrument was exchangeable for the stock or stocks on which the index is based and (ii) at the time when a cash payment of the indexed amount is made, the instrument was exchanged for those securities and they were immediately sold.

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<sup>136</sup> Section 249 is based on the view that a retirement premium attributable to a right to convert a debt instrument into stock of a corporation under common control with the issuer is not interest. Thus, the section provides a statutory basis for extending the exception to the general rule that all income from contingent payments is interest beyond True Convertibles to debt instruments that may be exchanged for stock of commonly controlled corporations. Section 249 applies only to debt instruments convertible into stock of the issuer or a corporation controlled by or controlling the issuer, using the section 368(c) definition of control. This definition is overly narrow in some respects (e.g., a class of nonvoting preferred held by a third party would avoid a finding of control, and ownership attribution is not taken into account), and a statutory amendment to adopt a broader definition seems warranted. Compare the definition of "issuer" in the last sentence of section 1.1272-1(f)(4)(i) (refers to section 108(e)(4)).

15. Foreign Currency Loans.

A. Retroactive Regulations.

Section 988, as added by section 1261 of TRA 1986, for the first time provides specific rules for the tax treatment of foreign currency transactions and specifically authorizes regulations on that subject. The new provision is effective for taxable years beginning after December 31, 1986.

In light of this imminent effective date, we strongly urge the Treasury not to issue regulations covering prior periods. In the legislative history to TRA 1986, Congress recognized that present law contains numerous uncertainties even for legitimate business transactions, and determined to provide a comprehensive set of rules in the area.<sup>137</sup> Since Congress has responded to this uncertainty with prospective legislation, without attempting to change the law for past years, it seems hardly appropriate for the Treasury to do so by regulation.

Moreover, the only possible reason for the issuance of regulations on a retroactive basis at this time would be to bolster the IRS's litigation position for past years. We believe this would be unfair to taxpayers. Taxpayers have acted and taken tax positions based on their analyses of existing authorities. While

the IRS may challenge these positions in court, taxpayers should be permitted to defend their position based on those authorities.

We recognize that the TRA 1984 OID amendments, particularly section 1275(d), implicitly authorize regulations on foreign currency transactions. However, those provisions, unlike TRA 1986, were not directed specifically at foreign currency transactions. It is difficult to read the legislative history of TRA 1986 and believe that Congress intended the Treasury to issue retroactive regulations under the authority of existing law. We therefore oppose the issuance of any regulations on foreign currency transactions that apply to periods before the effective date of section 988.

While we oppose retroactive regulations, the regulations under section 988 should provide explicit transition rules for transactions that began before 1987 and continue after 1986. For example, suppose that a U.S. taxpayer incurred debt denominated in a foreign currency in 1986 and hedged the borrowing by entering into a forward contract or contracts. Under pre-TRA 1986 law, the issuer would apparently deduct interest at the effective foreign exchange rate and realize gain or loss on the foreign currency delivered based on the difference between the purchase price under the forward contract and the fair market value of the foreign currency when it is delivered in payment of interest or principal. Under section 988, the two transactions would be integrated so

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<sup>137</sup> Conf. Rep. at 662; S. Rep. at 450; H. Rep. at 465.

that the borrower would be treated as having an interest cost determined with reference to its dollar payments under the forward contract. While as noted above, section 988 is effective for taxable years beginning after December 31, 1986, there is no indication in the legislation or the legislative history as to what is to happen to a borrower who has been accounting for a pre-1987 foreign currency indebtedness under the old rules. If there is no transition rule, the transaction will ultimately not come out right as an economic matter (even though it would under the old rules had they been unchanged). Perhaps the easiest way to handle the situation would be to provide a one time adjustment to the borrower in its first taxable year to which the new rule applies that would place it on the same basis as it would have been in had the new rule applied & initio. An alternative would be to spread this difference over the remaining life of the obligation.

B. Section 988.

This report is not intended as a comprehensive commentary on section 988. However, we do wish to raise a number of issues that require prompt consideration in the context of the OID rules.

(a) The legislative history indicates that, pending the issuance of regulations, OID for an accrual period will be determined in terms of units of foreign currency. The units so accrued in any accrual period will then be translated into dollars on the basis of current

exchange rates to determine taxable income and increases in the adjusted issue price. Exchange gains and losses attributable to amounts included in the adjusted issue price will be recognized when principal is repaid.<sup>138</sup> Thus, for example, if the same number of units is borrowed as is returned at maturity, there will be no exchange gain or loss until repayment of principal at maturity, regardless of intervening changes in exchange rates. We agree with the rejection in the legislative history<sup>139</sup> of the alternative rule under which exchange gain or loss on future principal payments would be accrued each year on the basis of current exchange rates. We therefore believe the temporary rule should also be the permanent rule.

(b) Consistent with this conclusion, we support the rule in section 1.1274-6(c) that in the case of a foreign currency loan, the applicable Federal rate is to be determined on the basis of the highest grade of marketable obligation in that currency. To make this determination more practical, however, consideration should be given to a rule that only the domestic market of the country whose currency is at issue need be taken into account.

(c) Section 988(d)(1) states that to the extent provided in regulations, if a section 988 transaction is part of a hedging transaction undertaken to reduce the

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<sup>138</sup> S. Rep. at 461-3. The same approach was recommended in the 1983 Report at 1005-1006.

<sup>139</sup> S. Rep. at 452-3, H. Rep. at 467

risk of currency fluctuations, all transactions that are part of the hedging transaction are to be integrated and treated as a single transaction or otherwise treated consistently. This provision is explained at some length in the legislative history.<sup>140</sup>

(i) This provision is not self-operative, but requires the issuance of regulations to be effective. We strongly urge the Treasury to act as quickly as possible in providing guidance to taxpayers as to the types of transactions that will be covered. At the very least, the Treasury should issue an announcement that the regulations will follow the principles of the legislative history.

(ii) Section 988(d)(2)(A) indicates that the hedging rule applies to a hedge entered into "primarily" to reduce the risk of foreign currency fluctuations. We believe guidance is necessary to address the case where a hedge is entered into to reduce both the risk of interest rate fluctuations and the risk of currency fluctuations.

For example, a U.S. person borrowing foreign currency on a floating interest rate basis might swap the obligation into a fixed rate dollar obligation. In this situation, we believe the preferable result would be for the entire hedge to be treated, together with the

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<sup>140</sup> Conf. Rep. at 659, 663; S. Rep. at 464-8; H. Rep. at 475-7.

borrowing, as a single transaction.<sup>141</sup> The reasons supporting the single transaction approach apply equally to the interest rate and currency aspects of the hedge. Alternatively, the hedge could be hypothetically divided into two separate pieces, and only the foreign currency portion integrated with the borrowing. The latter approach would, however, be extremely complicated to apply and would serve no useful purpose.

Finally, we would strongly oppose treating such a hedge as ineligible per se for integration with the borrowing, or even of trying to resolve the impossible question of the "primary purpose" for the hedge. Either such approach could force taxpayers to enter into two separate hedge agreements, one to hedge currency risks and another to hedge interest rate risks, where a single one was available and would have sufficed. We see no tax policy reason to require parties to enter into artificial arrangements that will result in an increase in transaction costs.

(iii) The Treasury should also make clear at an early date that, contrary to the usual rule under section 163(e) that OID deductions parallel OID inclusions by an original holder of debt, the tax treatment of the issuer of debt is to be determined without regard to any hedging transactions that might be entered into by the holder (and vice versa). Each party to a foreign currency borrowing should be treated solely

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<sup>141</sup> Some support for this result might be derived from Conf. Rep. at 167, indicating that a hedging position may include an interest rate swap denominated in a nonfunctional currency.

on the basis of its own transactions with the opposite party and with third parties. We recognize that this could result in the parties to a single borrowing transaction reporting income and deductions in different amounts or at different times.<sup>142</sup> However, the tax differences would match differences in economic consequences, in a manner analogous to the difference that results under section 1272(a)(6) from the purchase of a debt instrument with an acquisition premium. While the possible need for inconsistent treatment of borrowers and lenders may seem obvious, it does not seem to have been explicitly acknowledged.

This principle should also apply to collateral effects such as information reporting and withholding; a U.S. person borrowing foreign currency must generally be permitted to report and withhold, if reporting or withholding is required, on the assumption that the lender has not entered into any hedging transactions. An

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<sup>142</sup> For example, suppose A loans to B 100 units of foreign currency FC at a time when \$1 = 1 FC. Assume B must pay 10 FC in interest at the end of years 1 and 2, and 100 FC in principal at the end of year 2. Assume FC turns out to be worth \$1.02 at the end of year 1 and \$1.04 at the end of year 2. If A remains unhedged, A will report income of \$10.20 in year 1 and  $\$10.40 + (\$104 - \$100) = \$14.40$  in year 2. If B hedged in a manner that exactly reflected future events by buying at the time of the borrowing 10 units of FC at \$1.02 for delivery in one year and 110 units at \$1.04 for delivery in 2 years, B will be treated as having issued an OID obligation with an issue price of \$100, qualified periodic interest payments of \$10.20 at the end of years 1 and 2, and a payment included in the stated redemption price at maturity of \$104.20 at the end of year 2. In this example, the aggregate dollar amounts of income and deduction would be the same for both parties but the timing would be different. Had B's hedge not been precisely borne out by future events, the amounts of income and deduction reported by A and B would also be different.

exception might be appropriate in the context of a foreign lender if the lender provides the borrower with a certification comparable to Form 1001.

16. Omitted Items.

A. Mandatory Sinking Funds.

The final regulations should include rules for mandatory sinking funds along the lines proposed in the 1983 Report at 1010.

B. Issuance Expenses.

Consideration should be given to clarifying the treatment of issuance expenses (including underwriters' discount) in light of the general adoption of a constant yield method for amortizing original issue discount and premium. See 1983 Report at 1030.

C. TRA 1986 Amendments.

Section 1803(a)(11)(A) of TRA 1986 amended section 171 to require that premium be amortized based on a constant yield method. We recommend that the regulations under section 171 be amended to reflect this change and also, more generally, to conform the rules for amortizing bond premium to the rules for amortizing OID. This is particularly significant in light of the fact that any premium bond can in effect be converted into an obligation having OID and by stripping the bond

subjecting it to section 1286. We note in particular that premium would be amortized under section 171(b)(1)(B)(ii) based on the higher of the yield to a call date or the yield to the maturity date. This rule is inconsistent with section 1.1272-4(f) which, in the case of issuer call options, permits amortization of OID based on the lower of the yield to the call date or the yield to maturity. We recommend that the rule in section 171 be changed through regulations to eliminate this discrepancy.<sup>143</sup>

Section 1.61-12(c)(2) requires an issuer of bonds to include the net amount of any premium at which the bonds were issued in income. The regulation states that such premium "should be prorated or amortized over the life of the bonds." While the reference to amortization may permit premium to be included in income by issuers under a constant yield method, particularly in view of the amendment to section 171, section 1.61-12(c)(2) should be amended expressly to authorize this result.

TRA 1986 amended section 1272(a)(6) to permit a prepayment assumption to be taken into account in amortizing OID with respect to certain mortgage-backed and other obligations and to take account of differences between actual and assumed prepayment rates. The final regulations should reflect this amendment.

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<sup>143</sup> For further discussion of these issues, see letter from James M. Peaslee to Mikel M. Rollyson, Tax Notes, January 20, 1986 at 277.

## Appendix A

### Rates of Amortization of a Constant Amount of OID Based on Different Assumed Rates (Yields)<sup>139</sup>

#### OID Accruals<sup>140</sup>

Bond Year	(1) 2.24%/0	(2) 5%/24.34	(3) 10%/67.90	(4) 15%/110.76
1	18.05	15.85	12.40	9.58
2	18.46	16.66	13.67	11.07
3	18.88	17.50	15.07	12.80
4	19.30	18.39	16.62	14.79
5	19.74	19.32	18.32	17.09
6	20.18	20.30	20.20	19.75
7	20.64	21.32	22.27	22.83
8	21.10	22.40	24.55	26.38
9	21.58	23.54	27.07	30.48
10	22.07	24.73	29.84	35.23
	200.00	200.00	200.00	200.00

<sup>139</sup> Assumes a ten-year bond with semiannual interest payments, an issue price of 800 and a single payment of 1,000 at maturity.

<sup>140</sup> The four columns show aggregate annual accruals of OID based on the aggregate annual coupon payment of interest shown to the right of the slash at the head of each column which, given the other terms of the bond, produces the yield shown to the left of the slash. Thus, column (1) indicates that if no periodic interest is paid on the bond, the yield is 2.24%. The assumed rates are represented by the yields which range from 2.24% in column (1) to 15% in column (4). All yields shown are based on semiannual compounding.

## Appendix B

### Application of De Minimis Rule to Rule of 78s Loans

#### Example 1

1. Facts:
- (a) Monthly pay, self-amortizing obligation written on the rule of 78s with an original principal balance of \$3,000.
  - (b) Annual percentage rate = 12%.
  - (c) Term = 12 months (exactly one year).
  - (d) Level monthly payment = \$266.55.
  - (e) Rule of 78s effective interest rates range from 12.22% per annum in month 1 to 11.59% in month 12. Therefore, the amount of each monthly payment that is a qualifying periodic interest payment ("QPIP") is 1/12 of 11.59% (.0096591) of the rule of 78s unpaid principal balance immediately before such payment is made. The balance of the rule of 78s interest is included in the stated redemption price at maturity ("SRPM").

2. Determination of interest included in SRPM:

<u>Month</u>	<u>Rule of 78s Interest</u>	<u>QPIP</u>	<u>Interest In- cluded in SRPM</u>
1	30.55	28.98	1.57
2	28.01	26.70	1.31
3	25.46	24.39	1.07
4	22.92	22.06	.86
5	20.37	19.71	.66
6	17.82	17.33	.49
7	15.28	14.93	.35
8	12.73	12.50	.23
9	10.18	10.05	.13
10	7.64	7.58	.08
11	5.09	5.08	.01
12	2.55	2.55	0.00

Total interest included in SRPM = \$6.76

3. Comparison with de minimis amount:

Using the de minimis rule in section 1.1273-1(a)(3)(ii) applicable to installment obligations that call for principal payments that are made no more rapidly than under a self-amortizing installment obligation, the de minimis amount of OID is  $116\% \times \text{SRPM} \times \text{number of complete years to maturity}$ , or  $1/6\% \times \$3,006.76 \times 1 = \$5.01$ . Therefore, OID of \$6.76 is not de minimis.

Example 2

1. Facts:

- (a) Monthly pay, self-amortizing installment obligation written on the rule of 78s with an original principal balance of \$10,000.
- (b) Annual percentage rate = 18%.
- (c) Term = 48 months.
- (d) Level monthly payment = \$293.75.
- (e) Rule of 78s effective interest rates range from 20.08% per annum in month 1 to 14.43% per annum in month 48. Therefore, the amount of each monthly payment that is a QPIP is  $1/12$  of 14.43% (.012024) of the rule of 78s unpaid principal balance immediately before such payment is made.

2. Determination of periodic interest included in SRPM:

<u>Month</u>	<u>Rule of 78s Interest</u>	<u>QPIP</u>	<u>Interest In- cluded in SRPM</u>
1	167.35	120.24	47.11
2	163.86	118.72	45.14
3	160.37	117.16	43.21
4	156.89	115.55	41.34
5	153.40	113.91	39.49
6	149.91	112.22	37.69
7	146.43	108.72	37.71
8	142.94	106.91	36.03
9	139.46	105.05	34.41
10	135.97	103.15	32.82
11	132.48	101.22	31.26
12	129.00	99.23	29.77
13	125.51	97.21	28.30
14	122.02	95.15	26.87
15	118.54	93.04	25.50
16	115.05	90.89	24.16
17	111.56	88.70	22.86
18	108.08	86.47	21.61
19	104.59	84.19	20.40
20	101.11	81.88	19.23
21	97.62	79.52	18.10
22	94.13	77.12	17.01
23	90.65	74.68	15.97
24	87.16	72.19	14.97
25	83.67	69.70	13.97
26	80.19	67.10	13.09
27	76.70	64.49	12.21
28	73.21	61.84	11.37
29	69.73	59.14	10.59
30	66.24	56.41	9.83
31	62.76	53.63	9.13
32	59.27	50.81	8.46
33	55.78	47.95	7.83
34	52.30	45.05	7.25
35	48.81	42.10	6.71
36	45.32	39.11	6.21
37	41.84	36.06	5.78
38	38.35	33.01	5.37
39	34.86	29.91	4.96
40	31.38	26.75	4.63

41	27.89	23.55	4.34
42	24.40	20.31	4.09
43	20.92	17.03	3.89
44	17.43	13.71	3.72
45	13.95	10.34	3.61
46	10.46	6.94	3.52
47	6.97	3.49	3.48
48	3.49	3.49	0.00

Total interest included in SRPM = \$833.63

3. Comparison with de minimis amount:

Using the de minimis rule in section 1.1273-1 (a)(3)(ii) applicable to installment obligations that call for principal payments that are made no more rapidly than under a self-amortizing installment obligation, the de minimis amount of OID is  $1/6\% \times \text{SRPM} \times \text{number of complete years to maturity}$ , or  $1/6\% \times \$10,833.63 \times 4 = \$72.24$ . OID of \$833.63 is not de minimis.

## Appendix B

### Application of De Minimis Rule to Rule of 78s Loans

#### Example 1

1. Facts:
- (a) Monthly pay, self-amortizing obligation written on the rule of 78s with an original principal balance of \$3,000.
  - (b) Annual percentage rate = 12%.
  - (c) Term = 12 months (exactly one year).
  - (d) Level monthly payment = \$266.55.
  - (e) Rule of 78s effective interest rates range from 12.22% per annum in month 1 to 11.59% in month 12. Therefore, the amount of each monthly payment that is a qualifying periodic interest payment ("QPIP") is 1/12 of 11.59% (.0096591) of the rule of 78s unpaid principal balance immediately before such payment is made. The balance of the rule of 78s interest is included in the stated redemption price at maturity ("SRPM").

2. Determination of interest included in SRPM:

<u>Month</u>	<u>Rule of 78s Interest</u>	<u>QPIP</u>	<u>Interest In- cluded in SRPM</u>
1	30.55	28.98	1.57
2	28.01	26.70	1.31
3	25.46	24.39	1.07
4	22.92	22.06	.86
5	20.37	19.71	.66
6	17.82	17.33	.49
7	15.28	14.93	.35
8	12.73	12.50	.23
9	10.18	10.05	.13
10	7.64	7.58	.08
11	5.09	5.08	.01
12	2.55	2.55	<u>0.00</u>

Total interest included in SRPM = \$6.76.

1. Comparison with de minimis amount:

Using the de minimis rule in section 1.1273-1(a)(3)(ii) applicable to installment obligations that call for principal payments that are made no more rapidly than under a self-amortizing installment obligation, the de minimis amount of OID is  $1/6\% \times \text{SRPM} \times \text{number of complete years to maturity}$ , or  $1/6\% \times \$3,006.76 \times 1 = \$5.01$ . Therefore, OID of \$6.76 is not de minimis.

Example 2

1. Facts:

- (a) Monthly pay, self-amortizing installment obligation written on the rule of 78s with an original principal balance of \$10,000.
- (b) Annual percentage rate = 18%.
- (c) Term = 48 months.
- (d) Level monthly payment = \$293.75.
- (e) Rule of 78s effective interest rates range from 20.08% per annum in month 1 to 14.43% per annum in month 48. Therefore, the amount of each monthly payment that is a QPIP is  $1/12$  of 14.43% (.012024) of the rule of 78s unpaid principal balance immediately before such payment is made.

2. Determination of periodic interest included in SRPM:

<u>Month</u>	<u>Rule of 78s Interest</u>	<u>QPIP</u>	<u>Interest In- cluded in SRPM</u>
1	167.35	120.24	47.11
2	163.86	118.72	45.14
3	160.37	117.16	43.21
4	156.89	115.55	41.34
5	153.40	113.91	39.49
6	149.91	112.22	37.69
7	146.43	108.72	37.71
8	142.94	106.91	36.03
9	139.46	105.05	34.41
10	135.97	103.15	32.82
11	132.48	101.22	31.26
12	129.00	99.23	29.77
13	125.51	97.21	28.30
14	122.02	95.15	26.87
15	118.54	93.04	25.50
16	115.05	90.89	24.16
17	111.56	88.70	22.86
18	108.08	86.47	21.61
19	104.59	84.19	20.40
20	101.11	81.88	19.23
21	97.62	79.52	18.10
22	94.13	77.12	17.01
23	90.65	74.68	15.97
24	87.16	72.19	14.97
25	83.67	69.70	13.97
26	80.19	67.10	13.09

27	76.70	64.49	12.21
28	73.21	61.84	11.37
29	69.73	59.14	10.59
30	66.24	56.41	9.83
31	62.76	53.63	9.13
32	59.27	50.81	8.46
33	55.78	47.95	7.83
34	52.30	45.05	7.25
35	48.81	42.10	6.71
36	45.32	39.11	6.21
37	41.84	36.06	5.78
38	38.35	33.01	5.37
39	34.86	29.91	4.96
40	31.38	26.75	4.63
41	27.89	23.55	4.34
42	24.40	20.31	4.09
43	20.92	17.03	3.89
44	17.43	13.71	3.72
45	13.95	10.34	3.61
46	10.46	6.94	3.52
47	6.97	3.49	3.48
48	3.49	3.49	<u>0.00</u>

Total interest included in SRPM = \$833.63

3. Comparison with de minimis amount:

Using the de minimis rule in section 1.1273-1(a)(3)(ii) applicable to installment obligations that call for principal payments that are made no more rapidly than under a self-amortizing installment obligation, the de minimis amount of OID is  $1/6\% \times \text{SRPM} \times \text{number of complete years to maturity}$ , or  $1/6\% \times \$10,833.63 \times 4 = \$72.24$ . OID of \$833.63 is not de minimis.