DESCRIPTION OF THE TAX TREATMENT OF IMPUTED INTEREST ON DEFERRED PAYMENT SALES OF PROPERTY (AND H.R. 242 AND H.R. 2069)

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on April 24, 1985, to review the imputed interest rules of the Internal Revenue Code of 1954 as amended by the Deficit Reduction Act of 1984 (P.L. 98-369) (hereafter called the "1984 Act") and by the subsequent temporary legislation (P.L. 98-612) (hereafter called the "stopgap legislation"). The provisions of the stopgap legislation expire on July 1, 1985. The amendments made by the 1984 Act modified the imputed interest rules of prior law and expanded the original issue discount rules of prior law to apply to deferred payment obligations created in sales or exchanges of nonpublicly-traded property. The pamphlet collectively refers to these rules as the imputed interest rules.

The first part of the pamphlet [1] is a summary. The second part discusses the rules of present law relating to imputed interest and original issue discount. The third part provides an historical background of the development of the imputed interest rules. The fourth part provides an analysis of the effect of the imputed interest rules and the issues presented by those rules. Finally, the fifth part provides a description of the House bills (principally H.R. 242, introduced by Mr. Archer and others, and H.R. 2069, introduced by Mr. Matsui and others) that have been introduced thus far in the 99th Congress that affect the imputed interest rules.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of the Tax Treatment of Imputed Interest on Deferred Payment Sales of Property (and H.R. 242 and H.R. 2069)* (JCS-10-85), April 23, 1985.

I. SUMMARY

Present Law Rules

The amendments to the imputed interest rules adopted by Congress in the 1984 Act were part of a series of modifications to the Internal Revenue Code designed to more properly account for the time value of money. A principal motivation for these changes was to address perceived abuses by tax shelters.

The 1984 Act made two basic modifications to the Federal income tax treatment of imputed interest. First, the Act attempted to correct deficiencies in the then-existing imputed interest rules by providing that the amount of imputed interest would be determined by reference to an interest rate tied to the yields on U.S. Treasury obligations, instead of a fixed rate set by the Treasury Department. Under these rules, if interest is not stated at a rate at least 110 percent of the average yield on Treasury obligations, then interest is imputed into the transaction at a rate equal to 120 percent of the Federal rate. The effect of imputing interest income into the transaction is not to increase the amount paid by the buyer to the seller, but to recharacterize a portion of the payments (designated as principal by the parties) as interest for Federal income tax purposes.

Second, the 1984 Act expanded the rules dealing with original issue discount to cover many deferred payment obligations arising from the the sale of property. The purpose of this change was to insure that interest deductions taken by the buyer during a year do not exceed the interest income reported by the seller during that year.

In response to concerns expressed about the potential impact of the new rules, Congress passed the stopgap legislation at the end of the 98th Congress. Under the stopgap legislation, the test rate on the first $2 million of borrowed amounts is 9 percent on sales or exchanges of property occurring before July 1, 1985.

House Legislative Proposals

In the current session, four bills have been introduced in the House of Representatives relating to the imputed interest rules. H.R. 242 (introduced by Messrs. Archer, Campbell, Duncan, Thomas, Crane, Heftel, and others) would repeal the changes that the 1984 Act made in these rules. In addition, H.R. 549 (introduced by Mr. Anderson) and H.R. 878 (introduced by Mr. Hammerschmidt) are identical to H.R. 242. H.R. 2069 (introduced by Messrs. Matsui, Jacobs, Ford, Jenkins, Heftel, Anthony, Flippo, Campbell, and Mrs. Kennelly) generally provides a lower rate at which interest must be stated to avoid the imputation of additional interest, and also a lower rate for imputing additional interest. The bill also provides that the buyer and seller may both account for interest on the cash method in transactions where the borrowed amount does not exceed $4 million. Also, under the bill, assumed loans and wraparound financing would be excepted from the imputed interest rules.

II. PRESENT LAW

A. Timing of Inclusion and Deduction of Interest

Treatment of original issue discount as interest

If, in a lending transaction, the borrower receives less than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of money.[1] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[2]

Definitions

"Original issue discount" is defined as the excess of a debt instrument's "stated redemption price" at maturity over its "issue price" (provided such excess is not less than a certain *de minimis* amount).

"Issue price" is generally (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,[3] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, the amount determined under section 1274, as discussed below.

"Stated redemption price" at maturity includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period" (each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months prior to the date of maturity). The adjustment to the issue price for each accru-

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[1] *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[2] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982 and the 1984 Act greatly expanded the number and types of obligations to which the OID rules apply.

[3] Presently, only stock or securities traded on an established securities market are treated as "publicly traded." However, section 103 of the Technical Corrections Act of 1985 (H.R. 1800) would grant the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

al period is determined by multiplying the "adjusted issue price" (the issue price increased by adjustments prior to the beginning of the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction.[4]

B. Determination of Issue Price in Debt-for-Property Transactions: Section 1274

In general

Section 1274, added by the 1984 Act, performs two distinct roles. First, section 1274 tests the adequacy of stated interest in a transaction and imputes additional interest where stated interest is inadequate. Second, section 1274 determines the issue price of a debt instrument. This, in turn, invokes the application of the OID rules which require the issuer and the holder of the debt instrument to use the accrual method of accounting for any interest (whether stated or imputed) that is not paid currently. The effect of section 1274 is to require the lender and borrower to account for interest annually in an amount equal to the greater of the stated interest rate or a rate deemed to be adequate (i.e., the "imputation rate," described below).

Subject to certain exceptions, described below, section 1274 determines the issue price of a debt instrument issued in connection with the sale or exchange of property if (1) neither the instrument nor the property received in exchange for the instrument is publicly traded, (2) some or all of the payments under the instrument are due more than six months after the sale, and (3) the stated redemption price at maturity of the instrument exceeds its stated principal amount (if there is adequate stated interest) or its "imputed principal amount" (if there is inadequate stated interest).

Determination of issue price and amount of OID under section 1274

The issue price of an obligation subject to section 1274 is the stated principal amount of the instrument unless there is inadequate stated interest. In order to determine whether stated interest is adequate, the stated principal amount of the debt instrument is compared to the "testing amount"—the amount determined by discounting all payments due under the instrument at a prescribed

[4] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid the lender the annual interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender is then deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

test rate. An instrument contains adequate stated interest if the stated principal amount is less than or equal to the testing amount.

If a debt instrument does not contain adequate stated interest, section 1274 deems the principal amount (and the issue price) of the instrument to be the "imputed principal amount." The imputed principal amount is the amount determined by discounting all payments due under the instrument using a prescribed imputation rate, which is higher than the test rate.

In effect, where section 1274 applies, it will impute additional interest if the debt instrument does not bear interest at a rate at least equal to the prescribed testing rate. Moreover, if such interest is not unconditionally payable at least annually,[5] the OID rules will require periodic inclusion and deduction of the accrued but unpaid interest. The OID rules also apply if an instrument provides for adequate interest payable at least annually, but also provides for fixed additional amounts of interest that are not paid currently. In such a case, the instrument is deemed to contain OID equal to the additional interest. Pursuant to the OID rules, a portion of this OID is reported as income by the lender and deducted by the borrower currently.[6]"

"Test rates" and "imputation rates"

Under section 1274, whether there is adequate stated interest in a transaction is determined by reference to an appropriate test rate. The test is the rate in effect on the first day there is a binding contract for the sale or exchange of property. All test and imputation rates are applied using semiannual compounding.

General rule.— For sales or exchanges after December 31, 1984, of property eligible for the investment credit, and for all sales or exchanges after June 30, 1985, the test rate is 110 percent of the "applicable Federal rate," and the imputation rate is 120 percent of the "applicable Federal rate."

Applicable Federal rate.—The statutory applicable Federal rate ("AFR") for an obligation is a rate based on the weighted average of yields over a period of six months for marketable obligations of the United States Government with a comparable maturity. The rates are redetermined at six-month intervals for three categories of debt instruments: short-term maturity (three years or less), mid-term maturity (more than three years but not in excess of nine years), and long-term maturity (more than nine years).[7]

Responding to a problem that may exist where interest rates decline after the period in which the AFRs were determined, the Treasury Department has promulgated temporary regulations that provide more current applicable Federal rates. Under those regula-

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[5] As discussed below, the prescribed test rates are based on semiannual compounding. Accordingly, if interest is payable annually, the amount payable must reflect the compounding of the nominal test rate. If interest is payable at intervals more frequent than semiannual, the nominal rate may be adjusted appropriately. For illustration of the adjustments to the prescribed rate based on the intervals at which interest is paid, *see, e.g.*, Rev. Rul. 85-38, 1985-14 I.R.B. 6.

[6] An exception from the accrual accounting requirement is provided for debt issued in connection with sales of property not eligible for the investment credit and used in the active trade or business of farming. This exception applies only if the sale takes place after December 31, 1984, and prior to July 1, 1985, and the borrowed amount does not exceed $2 million. Interest on such debt is accounted for by both the borrower and the lender on the cash method of accounting.

[7] Appropriate adjustments to the rates are to be made for application to debt instruments, the interest on which is wholly or partly exempt from tax (sec. 1288).

tions, each month the Treasury determines a set of rates, using the same methodology described above for determination of the statutory AFR, except that the rates reflect the average yields for one-month periods. If 110 percent of the applicable monthly rate or 110 percent of the monthly rate for either of the two preceding months is lower than the statutory rate for a transaction, then 110 percent of the lowest of such three monthly rates is the test rate for the transaction, and 120 percent of that rate is the imputation rate.

Special rule for certain transactions before July 1, 1985.—For sales or exchanges after December 31, 1984, and before July 1, 1985, of property other than new property eligible for the investment credit, the test rate for "borrowed amounts" not exceeding $2 million is 9 percent. The test rate for borrowed amounts exceeding $2 million is a "blend" of 9 percent on the first $2 million and 110 percent of the AFR on the excess. In applying the $2 million limitation, all sales or exchanges that are part of the same transaction (or a series of related transactions) are treated as one transaction, and all debt instruments arising from the same transaction (or a series of related transactions) are treated as one debt instrument. The imputation rate for transactions during this same period is 10 percent for borrowed amounts up to $2 million and a blend of 10 percent and 120 percent of the AFR for borrowed amounts exceeding $2 million.

Limitation on principal amount of a debt instrument

Notwithstanding the computation of "issue price," discussed above, (and, accordingly, the buyer's basis in the property), the principal amount of any debt instrument under section 1274 in a "potentially abusive situation" is equal to the fair market value of the property sold.[8] This limitation applies whether the stated interest is adequate or inadequate under section 1274.

A potentially abusive situation includes any transaction involving a "tax shelter" (as defined in section 6661(b)(2)(C)(ii)). It also includes any other situation that, because of (1) recent sales transactions, (2) nonrecourse financing, (3) financing with a term beyond the economic life of the property, or (4) other circumstances, is of a type which the Secretary by regulation identifies as having a potential for abuse.

Where the principal amount of an obligation is reduced pursuant to the fair market value limitation, the principal amount in excess of the fair market value of the property may be treated as contingent purchase price with respect to the property, thus giving rise to additional basis to the purchaser if and when such amount is paid to the seller.

Exceptions

Debt instruments arising from certain transactions are specifically excepted from section 1274. However, these debt instruments

[8] The principal amount of the note is reduced to reflect the fair market value of other consideration involved in the transaction. This provision prevents both overstatement *and* understatement of the buyer's basis in the property. The purpose of the latter restriction is to prevent the intentional overstatement of OID. A taxpayer might be motivated to overstate the interest element of a sale, for example, if the property involved in the sale were nondepreciable or the seller were not subject to U.S. tax on interest income.

may be subject to section 483. As discussed below, section 483 tests the adequacy of interest in a debt instrument without requiring annual inclusion and deduction of accrued but unpaid interest. Debt instruments that are excepted from section 1274 are as follows:

Personal-use property.—Issuers (but not holders) of debt instruments issued in exchange for property, substantially all of which will not be used by the issuer in a trade or business or held by the issuer for the production or collection of income, are excepted from section 1274. Accordingly, a cash method issuer of such an obligation may claim interest deductions only for amounts of stated interest actually paid during the taxable year.

Annuities.—Section 1274 does not apply to an annuity to which section 72 applies and the liability for which depends in whole or in substantial part on the life expectancy of any individual. In addition, section 1274 does not apply to any annuity (whether or not dependent upon life expectancy) issued by an insurance company subject to tax under Subchapter L, provided the annuity is issued (1) in a transaction in which only cash or another annuity contract meeting the requirements of this exception is exchanged for the annuity, (2) upon exercise of an election under a life insurance policy by a beneficiary thereof, or (3) in a transaction involving a qualified pension or employee benefit plan.

Patents.—An exception is provided for payments attributable to a transfer of a patent, provided the transfer is eligible for capital gain treatment under section 1235 and such payments are contingent upon the productivity, use, or disposition of the patent. Thus, the exception does not apply in the case of a deferred lump-sum amount payable for a patent.

Farms.—Section 1274 does not apply to debt instruments received by an individual, estate, or testamentary trust, by a small business corporation (as defined in section 1244(c)(3)), or by certain partnerships [9] in exchange for a farm. This exception applies only if the sales price does not exceed $1 million.[10]

Principal residences.—Debt instruments received by an individual as consideration for the sale or exchange of that individual's principal residence (within the meaning of section 1034) are not subject to section 1274, regardless of the amount involved in the transaction.

Total payments not exceeding $250,000.—Section 1274 does not apply to any debt instrument given in exchange for property if the sum of (1) the payments due under the instrument (whether designated principal or interest) and under any other debt instrument given in the transaction, and (2) the fair market value of any other consideration given in the transaction, does not exceed $250,000.[11]

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[9] I.e., those partnerships whose capital is not in excess of the limits specified in section 1244(c)(3).

[10] Sales and exchanges that are part of the same transaction or a series of related transactions are treated as one sale or exchange, in order to prevent taxpayers from avoiding the $1 million limitation by dividing what is in substance a single transaction into two or more smaller transactions. The exception for farms as well as the exceptions following are nevertheless subject to section 483, as more fully discussed in the text below.

[11] This exception is subject to an aggregation rule similar to that provided under the farm sale exception.

Land transfers between related persons.—Finally, section 1274 does not apply to an instrument to the extent that section 483(f), relating to certain sales of land between related parties, applies. Thus, interest attributable to that portion of a debt instrument within the $500,000 limitation of section 483(f) is not subject to OID reporting.

C. Measurement of Principal and Interest in Transactions Not Subject to the OID Rules: Section 483

In general

Section 483 generally applies to nonpublicly traded debt instruments given in exchange for nonpublicly traded property where such debt instruments are not subject to section 1274. Under section 483, an instrument is tested for adequate stated interest in the same manner, and using the same test rates manner, as under 1274. Where stated interest is inadequate, section 483 recharacterizes a portion of the principal amount of the instrument as interest, equivalent to the additional amount of OID that section 1274 would impute.[12] However, unlike section 1274, section 483 does not require imputed interest (or stated interest) to be accounted for on an accrual basis. Stated interest on a debt instrument subject to section 483 is accounted for under the taxpayer's usual method of accounting. Imputed interest is accounted for by cash method taxpayers when the payments, portions of which are recharacterized by section 483 are made, or by accrual method taxpayers when such payments are due. The portion of the imputed interest that is allocated to a payment is that portion of the total imputed interest which, in a manner consistent with the method of computing interest under the OID rules, is properly allocable to such payment.

Exceptions

Section 483 contains the same exceptions for sales of personal-use property, annuities, and patents that apply to section 1274. In addition, section 483 does not apply where the sales price of the property does not exceed $3,000.

D. Regulatory Authority

The Treasury Department has authority to issue regulations dealing with the treatment of transactions involving varying interest rates, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments not specifically dealt with in the statute, and other circumstances. The regulatory authority granted to the Treasury Department contemplates possible modification of the generally applicable rules where appropriate to carry

[12] In the case of a sale after June 30, 1985, of a principal residence where the purchase price does not exceed $250,000 or of farm land where the price does not exceed $1 million (where such sale would qualify for exception from section 1274), the test rate may not exceed 9%, and imputation rate may not exceed 10%. If the purchase price of a principal residence exceeds $250,000, these limits apply to the portion of the deferred payments that $250,000 bears to the sales price; the rates based on the AFR apply to the remainder. In addition, for sales or exchanges of land between an individual and that individual's brothers, sisters, spouse, ancestors or lineal descendants, the test rate under section 483 may not exceed 6%. This preferential rate applies only to the extent that the sales price of the land, and the sales price of all prior sales of land between the same individuals, is less than or equal to $500,000.

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out the purposes of the statute, including the provision of exceptions for transactions not likely to significantly reduce the tax liability of the purchaser by reason of overstatement of the basis of the acquired property.

Pursuant to its regulatory authority, the Treasury Department has provided monthly rates in order to address the problems that may arise where the statutorily determined rates are significantly higher than prevailing market interest rates.

E. Assumptions

Neither section 483 nor section 1274 applies to the following debt obligations assumed in connection with the sale or exchange of property, or to debt obligations which property is taken subject to, provided that the terms and conditions of the obligation are not modified in connection with the sale:

Pre-October 16, 1984 obligations

Loans made on or before October 15, 1984, and assumed after December 31, 1984, in connection with a sale or exchange of property, are not subject to section 483 or section 1274 by reason of such assumption. This exception also applies if property is taken subject to a loan made on or before October 15, 1984. This exception does not apply, however, if the purchase price of the property exceeds $100 million.

Residences

Loans assumed in connection with a sale of a residence by an individual, estate, or testamentary trust are exempt from section 483 and 1274 if either (1) at the time of the sale, the property was the seller's (or if applicable, the decedent's) principal residence (within the meaning of section 1034) or (2) during the two-year period prior to the sale, no substantial portion of the property was of a character subject to an allowance for depreciation. Thus, an assumption of a loan in connection with the sale of a principal residence, or of a vacation home on which a taxpayer may not claim depreciation (e.g., by reason of section 280A), generally is not subject to testing for unstated interest under section 483 or 1274. This exception does not apply, however, to a sale of property that was at any time held by the seller for sale to customers in the ordinary course of business.

Farms

Neither sections 483 or 1274 apply to loans assumed in connection with a sale by a "qualified person" of real property used as a farm (within the meaning of section 6420(c)(2)) at all times during the three-year period prior to the sale. The exception also applies to loans assumed in connection with the sale of tangible personal property used by the seller of such a farm in the active conduct of a farming business that is also sold in connection with the sale of such a farm for use by the buyer in the active conduct of a farming business. The term "qualified person" includes an individual, estate, or testamentary trust, or a corporation or partnership having 35 or fewer shareholders or partners immediately prior to the sale or exchange, owning at least a 10-percent interest in the property sold.

Trades or businesses

Finally, loans assumed in connection with a sale by a "qualified person" of a trade or business are exempt from sections 483 and 1274. Trade or business has the same meaning as under section 355, except that the rental of real estate under no circumstances qualifies as an active business for this purpose. For purposes of this exception, the term "qualified person" has the same meaning as in the exception for assumptions in connection with the sale of farm properties except that the sale must constitute a disposition of the seller's entire interest in the trade or business and in all substantially similar trades or businesses.

An exception is also provided for a sale of real property used in an active trade or business (as defined above) by someone who would be a qualified person but for the fact that his entire interest in the trade or business is not being sold. Thus, for example, loans assumed in connection with a casual sale by a sole proprietor of real property used in his business could be exempt from sections 1274 and 483.

The trade or business property exception does not apply to a sale of property qualifying under the farm exception, or to property that is new property eligible for the investment credit in the buyer's hands.

F. Relationship to Other Code Provisions

Section 482

Under section 482, the Treasury Secretary has authority to allocate income, deduction, credits, or other allowances among commonly controlled organizations or trades or businesses to the extent required to prevent evasion of taxes or clearly to reflect income. Existing regulations under section 482 set forth certain safe-harbor interest rates the use of which will prevent the Secretary from applying section 482. Since these rates do not necessarily reflect true market rates, the 1984 Act required the Treasury Department to provide new safe-harbor interest rates under section 482 that are consistent with the rates applicable under sections 483 and 1274.

Section 1274 and section 483, as amended, were not intended to supersede section 482 in the case of deferred payment sales of property between commonly controlled organizations. Thus, these sections do not affect the Treasury Department's regulatory authority to test, under an arm's-length standard, the interest rate charged on loans extended in connection with the sale or exchange of property between members of a controlled group.

Section 7872

Section 7872 generally provides that certain loans bearing interest at a below-market rate are to be treated as loans bearing interest at the market rate accompanied by a payment or payments from the lender to the borrower which are characterized in accordance with the substance of the particular transaction (e.g., gift, compensation, dividend, etc.). The market rate of interest for purposes of section 7872 is assumed to be 100% of the AFR.

Section 7872 applies to (1) loans where the foregone (i.e., below-market) interest is in the nature of a gift, (2) loans to an employee from a employer or to an independent contractor from one for whom the independent contractor provides services, (3) loans between a corporation and a shareholder of the corporation, (4) loans of which one of the principal purposes of the interest arrangement is the avoidance of any Federal tax, and (5) to the extent provided in regulations, any below-market loan if the interest arrangement of such loan has a significant effect on any Federal tax liability of either the lender or borrower. The application of section 7872 is limited by certain *de minimis* exceptions and, for certain gift loans, by the net investment income of the borrower.[13]

It is possible that some transactions may literally fall within the scope of both sections 1274 or 483 and section 7872. Under present law, if a transaction is subject to section 1274 or section 483, section 7872 does not apply.[14] Moreover, Congress intended that taxpayers could not couple a sale or exchange of property with a loan at 100% of the AFR in order to avoid the application of section 1274 or section 483.[15]

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[13] For a more detailed description of the provisions of section 7872, *see* Joint Committee on Taxation, 98th Cong. 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (JCS-41-84), 524-538 (Comm. Print, December 31, 1984).

[14] Section 7872(f)(8).

[15] H.R. Rep. No. 861, 98th Cong. 2d Sess. 888 (Conference Report, June 23, 1984). This statement presupposes that the test rate under section 7872 would generally be lower than the test rate under sections 1274 or 483. When the 1984 Act was passed, it appeared to Congress that this would be the case (with the exception of the transitional period prior to the effective date of section 1274 and the amendments to section 483).

III. HISTORICAL BACKGROUND

A. Imputed Interest Rules

Imputed interest rules were first enacted in 1964 in response to a perceived potential for abuse in installment sales of property. Prior to that time, some courts had held that, where the parties to a sale provided contractually that no interest was due on deferred payments or that interest was payable at a rate below the prevailing market rate, the contract's designation of payments as principal or interest generally must be respected for tax purposes.

Congress recognized that it was possible to achieve significant tax benefits by structuring a transaction to include a below-market rate of interest. When a contract states an inadequate interest rate, the true purchase price of the property is overstated because interest payments have been characterized as sales price, or loan principal.[16]

This recharacterization of interest as sales price, although of no economic significance to the parties, could have important tax consequences. If the property sold was a capital or a section 1231 (trade or business) asset to the seller, then the seller would have transformed interest income, which should be taxable currently as ordinary income, into tax-preferred capital gain income. If the property was depreciable in the hands of the purchaser, then the buyer would be entitled to higher depreciation deductions whose value may be more than the value of the lost interest deductions. Moreover, if the property was tangible personal property used in a trade or business or held for the production of income, then the buyer would be entitled to a larger investment credit.

As originally enacted, section 483 required that parties to a deferred-payment transaction state interest in the sales contract at or above a minimum "safe harbor" or "test" rate periodically set by the Treasury Department. If the parties failed to state interest at least at this minimum rate, section 483 imputed interest at a higher "imputation" rate, allocating each deferred payment between interest and principal by looking at the relative amounts of the payments.[17] The amount of the test and imputation rates was set by the Treasury Department. Just prior to the 1984 Act, the

[16] To illustrate, assume a sale of property with a value of $100 when the prevailing interest rate is 12 percent. The buyer agrees to pay and the seller agrees to accept $176 at the end of 5 years. From an economic standpoint, this $176 consists of $100 principal and $76 interest. Prior to the enactment of section 483, the parties might be able to structure the transaction as a sale for a larger purchase price but at a reduced rate of interest. For example, the transaction could be structured as a sale for a $153 note bearing simple interest at a rate of 3 percent simple interest, without affecting the economics of the transaction

[17] The amount of imputed ("unstated") interest allocated to a particular payment was the amount of the payment multiplied by the ratio of the amount of the payment to the total deferred payments.

safe harbor rate was 9 percent simple interest and the imputation rate was 10 percent, compounded semiannually.

In amending section 483 in 1984, Congress sought to remedy some of the perceived deficiencies in the statute that had led to both intentional and unintentional abuses by taxpayers. One deficiency was the test rate. The simple interest test rate under prior law did not reflect an economic rate of interest for three reasons. First, although the rate was occasionally changed by the Treasury Department,[18] it lagged significantly behind market interest rates. Second, the statute's use of a simple test rate ignored the compounding of interest on unpaid interest that occurs as an economic matter. Finally, the use of a single rate for all obligations regardless of the length of maturity failed to reflect the fact that lenders typically demand different returns depending on the term of the loan.

Another deficiency of the statute was the method of allocating imputed interest among payments. Some tax shelters attempted to exploit this method by deliberately structuring sales transactions to be treated as having unstated interest. Under a literal application of the statute and regulations, several years' interest charges arguably could be deducted by the buyer in the year of sale.

The need to resolve these deficiencies became more urgent as market interest rates reached historically high levels, and the potential for overstatement of purchase price and tax basis increased correspondingly. Moreover, the enactment of the Accelerated Cost Recovery System ("ACRS") in 1981 placed additional pressure on the imputed interest rules creating a greater incentive to overstate the basis of property. The liberal cost recovery allowances permitted under ACRS made it more likely that a buyer would be better off from a tax standpoint with a high purchase price and smaller interest deductions, than with a low purchase price and larger interest deductions. Thus, both parties could have a tax incentive to understate interest, and were permitted to do so by virtue of the interest rate specified as a safe harbor in the section 483 regulations.

B. Original Issue Discount

Prior to the Tax Reform Act of 1969, an accrual-method borrower could take deductions for accrued but unpaid interest while a cash-method lender could defer interest inclusions until maturity. Concern over the mismatching of interest income and deductions by lenders and borrowers in discount loan transactions led to the enactment in 1969 of provisions requiring inclusion in income of OID by the holder of certain debt obligations (former sec. 1232). The rules enacted in 1969 allocated OID on a straight-line basis over the life of the loan. This allowed borrowers larger interest deductions in the earlier years of a discount loan than were justified under an economic accrual formula. Lenders were correspondingly required to report a disproportionately large amount of interest income in the early years of the loan. In recognition of the short-

[18] The Treasury Department had changed the rates two times in the 20 years since the enactment of the imputed interest rules.

comings of these rules, Congress made further amendments to the OID provisions in 1982. Under the 1982 rules, both issuers and holders were required to report OID on a constant interest basis.[19]

Prior to 1982, the OID provisions applied only to corporate and taxable government obligations (other than U.S. Government savings bonds). The 1982 amendments extended these provisions to noncorporate obligations other than those of individuals. In addition, the OID rules prior to the 1984 Act did not apply to obligations that were not capital assets in the hands of the holder, or obligations issued in exchange for property where neither the obligation, nor the property received was publicly traded.

The reason for the exclusion of nontraded discount obligations issued for nontraded property was the perceived difficulty in these situations of determining the value of the property sold and hence, the issue price of, and the amount of OID implicit in, the obligation. If the value of property is not readily ascertainable, the allocation between principal and interest on the obligation is difficult to determine. As discussed above, the 1984 Act resolved this valuation problem by adopting a modified version of the approach used in section 483 to determine the principal amount of the loan.

[19] In 1983, the Internal Revenue Service issued a revenue ruling proscribing the deduction of interest in an amount in excess of the economic accrual of interest for the taxable year, in transaction's not subject OID rules. In Rev. Rul. 83-84, 1983-1 C.B. 9, the Service ruled that the amount of interest attributable to the use of money for a period between payments must be determined by applying the effective rate of interest (i.e., the yield to maturity) on the loan to the unpaid balance of the loan for that period. The unpaid balance of the loan is the amount borrowed plus the interest earned, minus amounts previously paid.

IV. ANALYSIS AND ISSUES

A. Determining the Proper Amount of Imputed Interest

Tax consequences of understatement of interest

Understatement of interest in a seller-financed sale of depreciable property results in an overstatement of both the buyer's depreciation deductions (and investment tax credit if applicable) and the seller's capital gain, and an understatement of both the buyer's interest deductions and the seller's interest income. The net tax effect of understatement of interest depends on a variety of factors including: (1) the relative tax rates of the buyer and seller; (2) the amount by which basis is overstated; (3) the depreciation method used, and the number of years the property is held, by the buyer; and (4) the term of the seller-financed mortgage where capital gains are reported on the installment method. In general, the overstatement of basis (attributable to below-market seller financing) is advantageous for tax purposes to the extent that it results in a magnification of the tax benefits of rapid depreciation, capital gains treatment, and installment reporting. The consequences of overvaluating basis are demonstrated below in two examples involving the sale of an office building with (1) a third-party market rate mortgage, and (2) a seller-financed mortgage at a below market interest rate.

The first example involves the sale of a fully depreciated office building for a $100 million note with interest payable at 13.5 percent (assumed market rate) and a balloon payment of principal in 18 years. The buyer and seller are both taxable at a 50-percent rate. In this case, the seller will recognize a capital gain of $100 million in the eighteenth year, giving rise to a tax liability of $20 million (assuming there is no depreciation recapture). Over the 18-year term of the note, the buyer will depreciate the full purchase price of the property, resulting in deductions of $100 million, and giving rise to a tax reduction of $50 million. Thus, the net effect of the sale is a reduction in tax revenues of $30 million ($50 million minus $20 million) over the 18-year period.[20] This example shows that the sale of depreciable property on the installment method can result in a reduction in tax revenues even if interest is stated at the market rate. However, the tax benefit arising from the installment sale rules and the preferential treatment of capital gains can, in many cases, be magnified as a result of understating interest.

In the second example, the parties to the sale of the office building, described above, agree to reduce the interest rate to 9.7 per-

[20] Interest payments of $13.5 million per year ($100 million times 13.5 percent) will be deducted by the buyer and included by the seller, resulting in no net revenue effect. Rental income from the property, and tax on this income, presumably would be unaffected by the sale.

cent and, as an offset, to raise the purchase price to $133.4 million.[21] Thus, the principal amount of the note is overstated, relative to a third-party mortgage, by one-third ($133.4 vs. $100 million). In this case, the seller will recognize a capital gain of $133.4 million in the eighteenth year, giving rise to a tax liability of $26.7 million. Over the 18-year term of the note, the buyer will depreciate the full purchase price of the property, resulting in deductions of $133.4 million, and giving rise to a tax reduction of $66.7 million. Thus, the net effect of the sale is a reduction in tax revenues of $40 million ($66.7 million minus $26.7 million) over the 18-year period.[22] This revenue loss is one-third greater than the $30 million revenue loss arising in the case where interest on the seller-financed mortgage was set at the market rate (see Table 1). Under the facts of this example, it can be concluded that the revenue loss arising from an installment sale of depreciable property increases in proportion to the overstatement of principal. Thus, the overstatement of principal in an installment sale of depreciable property can have significant tax consequences.

Table 1.—Tax Consequences of Understatement of Interest

[Dollar amounts in millions]

Item	Market rate mortgage	Below market mortgage
Stated interest rate (percent)	13.5	9.7
Stated principal amount	$100.0	$133.4
Maturity (years)	18	18
Total depreciation deductions	$100.0	$133.4
Taxable capital gains income	$40.0	$53.4
Net reduction in taxable income [1]	$60.0	80.0
Revenue loss over 18-year period [2]	$30.0	$40.0

[1] Total depreciation deductions less capital gains income.
[2] Revenue loss computed assuming buyer and seller are both in the 50-percent income tax bracket.

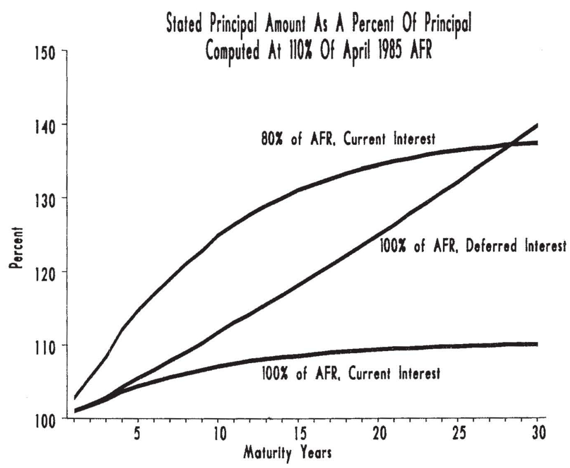
The amount by which the principal amount of indebtedness is overstated depends primarily on three factors: (1) the maturity of the note, (2) the extent to which interest is stated below the market rate, and (3) the degree to which accrued interest is deferred (i.e., not paid currently). The effect of these factors on the overstatement of principal is illustrated in Figure 1. For purposes of this figure, the prevailing mortgage interest rate is assumed to be 110 percent of the AFR.

If interest is stated at 80 percent of the AFR in an interest-only note, rather than at the assumed market rate (110 percent of the AFR), then the principal amount of indebtedness is overstated by

[21] The present value (discounted at the assumed market rate) of interest and principal on a 9.7 percent loan of $133.4 million is approximately equal to that on a 13.5 percent loan of $100 million, both on an interest-only basis with an 18-year maturity.
[22] Interest payments of $12.94 million per year ($133.4 million times 9.7 percent) will be deducted by the buyer and included by the seller, resulting in no net revenue effect. Rental income from the property, and tax on this income, presumably would be unaffected by the sale.

25 percent on a 10-year note, 34.5 percent on a 20-year note, and 37.5 percent on a 30-year note.[23] If a higher rate of interest is stated, for example 100 percent of the AFR, then overvaluation is reduced: the principal amount of indebtedness is overstated by 7.2 percent on a 10-year note, 9.4 percent on a 20-year note, and 10.1 percent on a 30-year note.[24] By contrast, if interest is again stated at 100 percent of the AFR but all interest payments are deferred to the date of maturity, then the amount of overvaluation is much greater: 11.8 percent on a 10-year note; 25 percent on a 20-year note; and 39.8 percent on a 30-year note. Thus, on a 30-year note, roughly equal amounts of principal overstatement can be achieved by (1) deferring all payments on a note that bears interest at 100 percent of the AFR or (2) charging and paying interest currently in an amount equal to 80 percent of the AFR.

FIGURE 1



The imputed interest provisions in the 1984 Act addressed only the interest rates used for testing and imputing interest in deferred payment sales of property. However, Figure 1 shows that where the test rate is below a market rate, deferred interest and long ma-

[23] In the limit, as maturity increases, the amount of overvaluation on an interest-only note at 80 percent of the AFR, relative to a similar note at 110 percent of the AFR, converges to the ratio of 110 to 80 (37.5 percent).
[24] In the limit, as maturity increases, the amount of overvaluation on a note at 100 percent of the AFR, relative to a note at 110 percent of the AFR, converges to the ratio of 110 to 100 (10.1 percent).

turities are also significant in determining the amount of principal overstatement and the concommitant tax benefits associated with such deferred payment sales.

Factors relevant to establishing the proper imputed interest rate

As demonstrated in the example above, distortions in the taxation of the parties to an installment sale can occur if the parties had unfettered discretion to characterize deferred payments as principal or interest for tax purposes. The role of the imputed interest rules is to establish parameters for allocating payments between principal and interest. The imputed interest provisions do not affect the total amount of payments flowing from the buyer of the property to the seller. They merely provide that, for tax purposes, a certain minimum amount of interest will be assumed to be inherent in the transaction. If the parties fail to state interest at, or above, a specified minimum rate, then the statute imputes interest at a higher rate.[25]

The most difficult issue posed by this statutory scheme is how this minimum interest rate should be fixed. Prior to 1984, the rate was set on an ad hoc basis by the Treasury Department. This system, however, produced unsatisfactory results, for the reasons discussed above. The 1984 Act introduced a self-adjusting, statutory mechanism for determining the test rate, designed to keep the rate reasonably consistent with current rates in the financial markets. Assuming that a self-adjusting mechanism is preferable to ad hoc regulatory determinations, the next issue becomes which "market" should provide the standard for comparison. Considerable controversy has arisen over this issue since the enactment of the 1984 Act.

In designing the statutory mechanism for determining the section 483 and 1274 test rates in the 1984 Act, Congress sought to produce a system that yielded a reasonable, conservative approximation of the rate at which a good credit risk with adequate security could borrow. Although this focus on the buyer-borrower's borrowing rate was consistent with the original legislative intent behind the enactment of section 483,[26] it has been suggested by some that the appropriate focus of the imputed interest rules is the seller's reinvestment rate (i.e., what rate of return the seller could have realized had he received cash from the buyer and invested in a security of comparable risk and maturity).

In this regard, it has also been suggested that the appropriate standard may be a rate somewhat lower than the rate at which the seller could have invested cash proceeds. It is argued that sellers of property may be willing to accept less than the rate of return they could realize on alternative investments for reasons wholly unrelated to taxes. For example, the seller may accept a below-market rate of interest in order to facilitate the sale of the property.[27] Fur-

[25] The legislative history of section 483 suggests that the imputation rate was assumed to be the normative rate, and that the inclusion of a lower test rate (which under the original statute had to be at least one percentage point below the imputation rate) was intended as "a de minimis rule to prevent the application of this provision in those cases where interest variations are relatively minor." H.R. Rep. No. 749, 88th Cong. 1st Sess. 72 (1963).

[26] *See* H.R. Rep. No. 749, 88th Cong., 1st Sess. 72 (1963).

[27] This is a common marketing strategy used, for example, by automobile dealers and homebuilders.

thermore, a below-market rate on seller financing may reflect the seller's ability to defer gain on the sale by using the installment method. Had he received the entire purchase price in cash, the seller would have been required to pay taxes on the entire gain in the year of the sale and would have had less after-tax proceeds to invest than if installment treatment were available. He can afford to charge the buyer less interest because he (the seller) is investing with before-tax, rather than after-tax, dollars.

Even if one accepts the premise that nontax factors influence the determination of rates in the seller-financing "market," there are inherent difficulties in allowing this market to establish the minimum acceptable rate for tax purposes. First, there is no readily ascertainable market rate for seller financing as there is for third-party financing. More importantly, the fact that the rates may be distorted by noneconomic factors, whether tax-related or not, makes them of questionable relevance in a tax system that, in theory, taxes transactions based on their true economic substance.

Finally, using a seller-financing rate as the test rate would result in a minimum rate that is below the prevailing market rate at which a buyer could borrow from a third-party lender. The tax consequences for both the seller and the buyer would vary, under some circumstances dramatically, depending on whether the transaction is seller-financed or financed with third-party loan. A buyer who finances a purchase with a third-party loan at the full market rate will presumably be willing (and perhaps able) to pay less for the property than if below-market seller financing were available, resulting in a lower tax basis for the buyer and less capital gain for the seller.[28]

[28] If one assumes that a buyer assesses the value of the property in present-value terms, the higher the interest rate on the financing used to carry the property, the lower the purchase price the buyer will be willing to pay.

Problems in developing a statutory mechanism for determining the test rate

Critics of the statute assert that the test rate established by the 1984 Act is flawed in several respects.

Overall level of the test and imputation rates

A common criticism of the 1984 Act is that the test and imputation rates are excessive relative to market interest rates. The 1984 Act established test and imputation rates, based on the AFR, to take account of varying maturities and fluctuations in market interest rates. The test rate provided in the 1984 Act was intended to be a lower bound estimate of the actual market rate of interest on similar obligations issued by third-party lenders. If designed correctly, the test rate would approximate the yield on a deferred payment note if it were sold in the secondary mortgage market (i.e., the "opportunity" cost of holding the note). Table 2 shows the most recent AFRs for the month of April 1985 (Rev. Rul. 85-38, 1985-14 I.R.B. 6).

Table 2.—Applicable Federal Rate for the Month of April 1985

[Annual rate]

Rate	Short-term	Mid-term	Long-term
100 percent of AFR	10.37	11.84	12.22
110 percent of AFR	11.43	13.06	13.49
120 percent of AFR	12.50	14.29	14.75

Criticism regarding the level of the test and imputation rates established by the 1984 Act can be evaluated by comparing the yield on U.S. government securities (used in the computation of the AFR) with yields on government-sponsored mortgages and mortgage-backed securities. Table 3 compares the average annual yield on fixed rate Federal Housing Administration ("FHA") mortgages, seasoned Government National Mortgage Association ("GNMA") securities, and 10-year U.S. government bonds, over the period 1972-1985. FHA mortgages are guaranteed by the Federal government and, consequently, yield less than otherwise comparable mortgages lacking a government guarantee. GNMA securities are backed by a pool of mortgages that are either insured by the Federal Housing Administration or guaranteed by the Veterans Administration.[29] Table 3 shows that over the period 1972–February, 1985 yields on government insured mortgages and securities backed by these mortgages have consistently exceeded the rate on government bonds of comparable maturity.[30]

Table 3.—Yield on Government Bonds and Government Sponsored Mortgages and Mortgage-backed Securities

[In percent]

Year	10-yr U.S. Govt. securuty	FHA [1] mortgages	Seasoned GNMAs [1] (by coupon rate)				
			6½	7¼	8	9½	15
1972	6.23	7.19	7.12		7.27		
1973	6.73	7.85	7.76		7.82		
1974	7.31	9.21	8.84		8.86		
1975	7.42	9.05	8.62		8.69		
1976	7.53	8.74	8.25	8.31	8.36		
1977	7.36	8.41		8.05	8.14		
1978	8.33	9.44		8.95	9.06		
1979	9.34	10.69		9.85	9.90		
1980	11.38	13.63		11.95	11.97		
1981	13.88	16.66			14.70	15.40	15.76
1982	13.18	16.11			14.26	14.61	15.64
1983	11.01				11.87	12.11	14.13
1984	12.45				12.97	13.32	14.31
1985 [2]	11.45				12.05	12.36	13.96
1985 [3]	11.07				11.72	12.09	13.73

[1] Yield computed assuming 12-year average maturity.
[2] January.
[3] February.

Source: Salomon Brothers, *An Analytical Record of Yields and Yield Spreads* (fifth edition).

The yield on government-sponsored mortgage instruments as a percentage of 10-year government bonds is shown in Table 4.[31] The average yield on FHA mortgages has exceeded the average yield on 10-year government bonds by more than 13 percent in every year over the 1972-1982 period. The yield on GNMA securities with coupon rates ranging from 6-1/2 through 15 percent has exceeded the yield on 10-year government bonds by more than 4 percent in every year since 1972 except 1980.

[29] Mortgage-backed securities generally yield less than the average interest rate on the underlying mortgages because (1) ownership of a share in a pool of mortgages is less risky than ownership of an individual mortgage, and (2) the owner of GNMA securities does not bear the costs of servicing the underlying mortgages.

[30] The yield on FHA mortgages and GNMA securities is computed assuming a 12-year average maturity. The actual maturity depends on the repayment of the underlying mortgages. Low fixed-rate mortgages in periods of rising interest rates tend to be repaid more slowly than high fixed-rate mortgages in periods of falling interest rates.

[31] The relative yields are computed directly from the yields shown in Table 3.

Table 4.—Yield on Government Sponsored Mortgages and Mortgage-backed Securities as a Percentage of 10-year Government Bonds

[In percent]

Year	10-yr U.S. Govt. security	FHA [1] mortgages	Seasoned GNMA's [1] (by coupon rate)				
			6 [1]	7¼	8	9½	15
1972	100	115.4	114.3		116.7		
1973	100	116.6	115.3		116.2		
1974	100	126.0	120.9		121.2		
1975	100	122.0	116.2		117.1		
1975	100	116.1	109.6	110.4	111.0		
1977	100	114.3		109.4	110.6		
1978	100	113.3		107.4	108.8		
1979	100	114.5		105.5	106.0		
1980	100	119.8					
1981	100	120.0			105.9	111.0	113.5
1982	100	122.2			108.2	110.8	118.7
1983	100				107.8	110.0	128.3
1984	100				104.2	107.0	114.9
1985 [2]	100				105.2	107.9	121.9
1985 [3]	100				105.9	109.2	124.0

[1] Yield computed assuming 12-year average maturity.
[2] January.
[3] February.

Source: Salomon Brothers, *An Analytical Record of Yields and Yield Spreads* (fifth edition)

The data in Table 4 demonstrate that the holder of a seller-financed mortgage, even if such mortgage were guaranteed by the Federal government, would generally not be able to sell the mortgage to a third-party lender at a price corresponding to a yield of less than 113 percent of the government bond rate, over the 1972-1982 period. This follows from the fact that banks were able to charge at least 113 percent of the government bond rate on FHA mortgages issued over the period. Even if the seller were able to pool such mortgages and obtain Federal insurance, it is unlikely that the pool could be sold to a third party lender at a price corresponding to a yield of less than 104 percent of the government bond rate. This follows from the fact that purchasers of government sponsored mortgage-backed GNMA securities obtained a yield of at least 104 percent of government bond rate in every year since 1972 except 1980. From this evidence it does not appear that the test rate (110 percent of the AFR) is too high relative to prevailing market interest rates. However, the historic relationship between government bond and mortgage yields may not prevail in the future. If the structure of yield differentials changes, then the test rate established in the 1984 Act could turn out to be either too high or too low.

Currentness of the Federal rate

The statutory mechanism for determining the AFR has been criticized as producing a rate which lags behind market rates during periods when interest rates are falling. This is attributable to the six-month length of the base period and the three-month period allowed for Treasury to compute and publish the Federal rates. This problem has been largely solved by the alternative system for computing the Federal rate which the Internal Revenue Service has promulgated in temporary regulations under section 1274.

Instability

Another criticism of the *of the Federal rate* mechanism for determining the AFR is that the index is too volatile during periods of rapidly rising rates. The argument has been made that, when interest rates in the financial markets rise precipitously, rates in the seller-financing market do not necessarily follow immediately or rise to the same degree. It has been argued that the test rates under sections 483 and 1274 should be allowed to lag behind financial market interest rates.

If one accepts the argument that volatility is a problem under the present system (that is, that test rates should not react immediately and precisely to fluctuations in the financial markets) several alternative solutions are possible. First, the base period over which yields on Treasury securities are averaged could be lengthened from 6 months to 12 months or longer. Second, some other index besides one based on Treasury securities could be used to determine the test rate. This could be an existing index or one specially designed for this purpose. The choice of this index would be influenced to some extent by conclusions about the appropriate rationale for the test rate, that is, whether it is a borrowing or a lending rate and whether it should vary from one type of property or market to another.

Finally, some stability in rates could be achieved by including a statutory limitation on the amount the test rate can rise from one period to the next. For example, the statute might provide that, notwithstanding the rates established under the general formula, the test rate may not increase more than a specified number of percentage points over some period of time.

Most of the interest rate limitations ("governors") that have been proposed reduce the rate that the interest index rises in periods of increasing rates, but do not reduce the rate that the index falls in periods of declining rates. Consequently, such governors not only serve to reduce interest rate volatility, but also reduce the average rate of the interest index over time. For example, one possible governor would be to limit the increase in the interest index to 10 basis points (one-tenth of one percentage point) per month. Over the 1968-1984 period, this governor would have reduced the index, on average, from 110 percent of the government rate to 95 percent of the Government rate in the short-term category, 100 percent in the mid-term category, and 103 percent in the long-term category (see table 5).

Table 5.—Effect of Interest Rate Governor

[Percent]

Item	Average monthly rate, 1968–84		
	Short-term	Medium-term	Long-term
100 percent of government rate [1]	8.45	8.68	8.72
100 percent of government rate with Governor [2]	8.03	8.70	9.01
Rate with Governor as a percent of government rate	95.00	100.00	103.30

[1] Computed from monthly yield on U.S. government securities as reported in Salomon Brothers, *An Analytical Record of Yields and Yields Spreads,* fifth edition. Maturities of 1, 2, and 3 years were used to compute the short-term rate; maturities of 4, 5, and 7 years were used to compute the medium-term rate; and maturities of 10, 20, and 30 were used to compute the long-term rate.

[2] The governor limits the increase in the interest index to 10 basis points per month.

Relief from the imputed interest rules for certain transactions

If, as some critics of the statute assert, the imputed interest rules as amended by the 1984 Act are too strict and harsh in their result, two approaches are possible. First, across-the-board relief could be provided by modifying the statute to make the test rate something less than 110 percent of the AFR. This could be done as an alternative to, or in conjunction with, the modifications to the index discussed above. Second, lower test rates could be provided for specified categories of transactions for which special relief is considered to be appropriate because application of the general rule is particularly harsh or unduly complex, or for other reasons.

Relief based on nature of transaction (functional approach).

Legislation introduced last year in both the House and the Senate would have provided special test rates under sections 483 and 1274 for certain types of transactions for which the imputed interest rules, as amended by the 1984 Act, were deemed to be particularly burdensome. H.R. 6172 (98th Cong.), introduced by Mr. Matsui, provided for a 9-percent test rate for sales of residential property up to $250,000, sales of business real property up to $500,000, and sales of farm property up to $1 million.

Transactions in this "triad" of categories are permanently exempted from the imputed interest rules to the extent an assumed loan is involved.

Relief based on size of transaction (threshold approach)

An alternative to the functional approach is to provide relief based on the dollar size of the transaction. Until July 1, 1985, the stopgap legislation provides a lower test rate for real property transactions to the extent the "borrowed amount" does not exceed

$2 million. Any amount in excess of this "threshold" is subject to the generally applicable test rate.

One possible rationale for a threshold approach is that relatively small transactions do not pose sufficient opportunities for abuse to warrant a full application of the imputed interest rules; taxpayers engaging in such transactions should not be held to the higher standard applicable to more sophisticated taxpayers.

As an alternative to determining the threshold based upon the size of the borrowed amount, a threshold could be based on the sales price of the property or on the total amount of the deferred payments.

A number of issues must be resolved if a threshold approach is adopted. The first issue is whether the threshold should be based upon the size of the borrowed amount, the sales prices of the property, or the total amount of the deferred payments. If the threshold is based on the borrowed amount, a decision must be made whether this includes only financing provided by the seller in the immediate transactions, or whether it also includes the amount of loans assumed (or taken subject to) by the buyer and third-party purchase money loans obtained by the buyer.

The second issue relates to when separate transactions will be aggregated for purposes applying the threshold. For example, if a single seller sells a 1/10 interest in a single property to ten different buyers, and each transaction uses the threshold amount, may the seller use the lower rate for each of the sales? What if each of ten co-owners of property sells his undivided interest in the property for the threshold amount to a single buyer? Should each seller be allowed to use the lower test rate on the entire amount of the debt, or should each get 1/10 of the threshold amount at the lower rate? How should the rule be applied in the case of property bought or sold by partnerships or other pass-through entities? Should the limitation be applied at the entity level or at the partner or beneficiary level, or both?

Finally, should the relief be available without regard to whether the taxpayer is a large public corporation or a limited partnership, on the one hand, or a relatively unsophisticated individual on the other? Should the relief be available for sales of property eligible for the investment credit, sales of property between related parties, or sale-leasebacks?

Before these issues relating to the measurement and application of the threshold can be resolved, it is necessary to determine precisely what objectives are sought to be achieved by relaxing the rules for transactions below the threshold. That is, which types of transactions deserve relief from the general rule and which do not?

Differences between test and imputation rate

Under section 483 as originally acted, the imputation rate was assumed to be the normative rate. The inclusion of a lower safe harbor rate was intended to reflect a *de minimis* exception; that is, interest would not be imputed where the stated rate did not vary significantly from what was considered to be an appropriate rate.

This two-rate system, which was preserved by the 1984 Act, has been criticized as creating undue complexity and a trap for the unwary.

The Committee may wish to consider eliminating the imputation rate in section 483 and 1274 and imputing interest at the test rate in cases where interest is stated at a rate below the test rate.

B. Method of Accounting

Where section 1274 applies to a transaction, the OID rules require both the seller and the buyer to account for all interest income and deductions arising from the seller-financed debt instrument as the interest accrues economically. As a result, the buyer may receive interest deductions prior to making any interest payments, and the seller may be required to include amounts in income prior to receiving any interest payments. Some seller-financed transactions, for valid non-tax business reasons, provide for little or no cash payments for an initial period (e.g., the property sold may generate little or no cash flow in that period). In these circumstances, it may be argued that it is unfair to require the seller to include amounts in income prior to receiving cash.

The mandatory accrual of interest income and deduction rule is intended to prevent mismatching of interest deductions and the related interest income. Requiring both buyer and seller to account for interest income and deductions on the cash method of accounting is another possible way of preventing mismatching. Under such a "cash-cash" regime, a buyer would not receive any deductions until interest is paid, and a seller would not include any interest in income until received, regardless of their normal methods of accounting.

Nevertheless, cash-cash accounting may generate unintended benefits that would prevent effective matching of income and deductions. For example, an accrual-method seller might sell property in a transaction that provides for deferred payments and results in the deferral of the interest income under the cash method. If the seller borrows in order to finance the buyer's obligation and is able to deduct currently the interest on that borrowing, then unrelated income may be "sheltered" from tax.

Another type of transaction in which the use of cash-cash accounting may undermine the goal of effective matching of income and deductions is a seller-financed sale to a buyer for whom the deferral of interest deductions imposes little or no tax cost (e.g., a tax-exempt or foreign entity). Since deferral of deductions would not be as costly to such a buyer as current inclusion would be to the seller, the parties have an incentive to arrange for deferral of both income and deductions to reduce the effective tax cost to both parties. Moreover, such a situation can be abused easily if the buyer resells the property using wraparound financing, thereby allowing the ultimate purchaser to take current interest deductions while allowing the original seller to defer interest income.

Rules would need to be developed, either in the statute or regulations, to prevent such unintended results and other possible abuses that could occur if cash-cash accounting is adopted for certain deferred payment transactions.[32] However, even with such rules,

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[32] As noted at in part II, *supra*, cash-cash accounting is permitted for interest on debt instruments issued in connection with certain sales of farms prior to July 1, 1985. The Treasury De-

Continued

cash-cash accounting would not prevent mismatching as effectively as accrual-accrual accounting.

C. Assumptions

Frequently, in connection with the sale or exchange of property, the buyer will assume a debt obligation of the seller or will take the property subject to an outstanding debt obligation. Either such transaction can be considered the economic equivalent of a transaction in which the buyer gives the seller a note, (in addition to any other consideration given in the transaction), the terms of which are identical to the terms of the obligation assumed and the payments on which are used to satisfy the seller's underlying obligation.[33]

If the transaction were structured in this equivalent form, either section 1274 or section 483, (if no exception were applicable), would test the adequacy of interest on the buyer's note. If the assumed debt bore interest at less than the applicable section 1274 or section 483 test rate, part of the principal on the buyer's note would be recharacterized as interest.[34] Accordingly, the buyer's basis and seller's amount realized would be reduced while the buyer interest deductions and seller's interest income would be increased.

Therefore, where debt bearing interest at less than the applicable test rate is assumed in connection with the sale or exchange of property, the buyer may receive an inflated basis for the property, and the seller may convert interest income to capital gain. This result can be avoided if section 1274 or section 483 were applied to the transaction as if the economically identical transaction had occurred (i.e. where the buyer had issued the seller a note that had the same terms as the assumed debt).[35]

In the view of the real estate industry, assumable debt relating to a parcel of real estate is inherently part of the "package" that is sold to the buyer. The industry would argue, therefore, that no adjustment of the terms should occur for income tax purposes. Never-

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partment is empowered to provide regulations that would prevent mismatching of interest income and deductions arising from the use of the cash method of accounting for such transactions.

[33] For convenience, the discussion will focus on only the assumption of a debt obligation, but is equally applicable to the taking of property subject to an existing debt. In addition, a similar issue arises in the case of so-called "warp-around" debt. In a transaction involving wrap-around debt, the seller of property leaves the original debt on the property outstanding and takes back an increased amount of purchase money debt from the buyer. For example, a seller owns property worth $1,000 with an outstanding third-party mortgage of $500. Instead of accepting the buyer's note for $500 and having the buyer assume the mortgage, the seller takes the buyer's note for $1,000 and remains the primary obligor on the mortgage. The buyer's $1,000 note is known as a wrap-around indebtedness because it is said to be "wrapped-around" the underlying debt of the seller.

[34] An alternative method of testing the adequacy of interest on assumed obligations is to test a hypothetical note, the terms of which include payments on the assumed debt as well as any payments on seller financed debt of the buyer. If this method were used, not every assumed loan bearing interest at less than the applicable test rate would require the recharacterization of principal, since including the seller financed debt, the buyer's entire obligation arising from the transaction may bear interest at a rate exceeding the test rate.

[35] Except for assumptions meeting the requirements for exemption from section 1274 and 483 (see Part II, *supra*), the assumption of a debt obligation in certain circumstances is treated as the issuance of a debt instrument by the buyer to the seller and is subject to the interest recharacterization provisions of section 483. In such a situation, the third party lender would have interest income and the seller would have interest deductions arising from the assumed debt obligation as if the debt had not been assumed; the buyer's basis and interest deductions as well as the seller's amount realized and interest income would be determined by reference to the assumed debt as recharacterized. Treas. Reg. sec. 1.483-1(f)(6)(iii).

theless, even if the assumable debt is part of the package being sold, a sound tax policy argument may be made that the income tax consequences of the transaction should reflect the underlying economic realities of the transaction.

D. Other: Effect of Changes in Sections 1274 and 483 Upon Section 7872

As discussed above, there is an overlap between sections 1274 and 483 and section 7872. Consequently, any changes made to section 1274 and 483 could affect the application of section 7872. Although present law provides that section 7872 does not apply where sections 1274 or 483 apply, it is clear that Congress anticipated that sections 1274 or 483 would require a higher rate of interest than section 7872.

It is less clear what result would have been intended where the test rate under section 7872 is generally higher than the test rate under section 1274 or 483. This situation can arise where a seller makes a loan to the buyer in connection with a sale or exchange of property that is exempt from both sections 483 and 1274 or where the loan is eligible under either of those sections for a test rate lower than 100% of the AFR. As a result of the stopgap legislation passed after the 1984 Act, which among other things provided for test rates lower than 110% of the AFR for certain transactions prior to July 1, 1985, the latter situation is more common than Congress had anticipated.

Therefore, if more transactions are excepted from sections 1274 and 483 or if the section 1274 test rate is lowered to less than 100% of the AFR, questions are raised whether the existing scheme, under which the section 1274 test rate would be used, should be preserved for any, some, or all transactions which may potentially fall under the coverage of both section 1274 and section 7872.

V. DESCRIPTION OF BILLS

A. H.R. 242—Messrs. Archer, Campbell, Duncan, Thomas, Crane, Heftel, and others

H.R. 242 (introduced by Mr. Archer and others)[36] would repeal section 1274 and the amendments to section 483 that were made by the 1984 Act. As a result, where a nonpublicly traded debt instrument is issued for nonpublicly traded property, only section 483 would apply to test the adequacy of interest on the instrument, and no OID reporting of accrued but unpaid interest would be required. Moreover, section 483 would be applied using the same test and imputation rates that applied prior to January 1, 1985. The effective date of H.R. 242 is July 1, 1985.

B. H.R. 2069—Messrs. Matsui, Jacobs, Ford, Jenkins, Heftel, Anthony, Flippo, Campbell, and Mrs. Kennelly

Under H.R. 2069 (introduced by Mr. Matsui and others), lower test and imputation rates would apply to transactions in which the borrowed amount does not exceed $4 million. A test rate equal to the lower of 9 percent or 80 percent of the AFR would apply to transactions below this threshold. If a transaction involved more than the threshold amount and 9 percent were lower than 80 percent of the AFR, then the test rate would be a weighted average or blended rate determined by applying 9 percent on the amount up to the threshold and 80 percent of the AFR on the excess.

Where inadequate interest is stated, the bill would impute interest at a rate equal to the lower of 10 percent or 90 percent of the AFR on amounts up to $4 million, and at a rate equal to 90 percent of the AFR on any excess.

The bill provides that, in the case of loans that are assumed (or taken subject to) in a sales transaction, the imputed interest rules and the OID rules shall not apply unless the terms of the loan are modified in connection with the assumption. For this purpose, the underlying ("wrapped") loan in a wraparound loan transaction would be treated as an assumed loan. Thus, the imputed interest rules and OID rules would apply only to the portion of the wraparound loan representing the seller's equity in the property.

The bill would exclude from the OID rules any debt instrument issued in a sale of property to be used as a residence by the obligor. This would modify present law in two respects. First, under the 1984 Act, only transactions arising from a sale of a principal residence of the *seller* are exempt from the OID rules. Under the bill, the focus is on the use of the property by the buyer. Thus, for ex-

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[36] In addition, H.R. 549 (introduced by Mr. Anderson) and H.R. 878 (introduced by Mr. Hammerschmidt) are identical to H.R. 242.

ample, builders would not be subject to the OID rules with respect to debt received from buyers of homes. Second, the exception from the OID rules would apparently apply without regard to whether the residence was a *principal* residence. Thus, vacation and other secondary homes would presumably be covered by the exception.

The bill would also repeal the provision of current law under which a cash-method borrower who uses the proceeds of the loan to purchase personal use property is denied an interest deduction in a taxable year for any amount in excess of the interest actually paid on the loan. Thus, for example, if a homebuilder sold a home to a customer under an installment sale contract stating that only principal was payable for three years, the buyer would be allowed to deduct interest at the imputation rate provided under section 483 during those three years.

Finally, the bill would require the parties to a transaction below the threshold to report interest income and deductions with respect to the debt instrument on the cash method, unless both parties agreed to report on an accrual basis.