[JOINT COMMITTEE PRINT]

PROVISIONS OF THE TAX REFORM ACT OF 1984 AFFECTING THE FEDERAL TAX TREATMENT OF INTEREST ON DEFERRED PAYMENT SALES OF PROPERTY

Scheduled for a Hearing

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON AUGUST 3, 1984

Prepared by the Staff

OF THE

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INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Committee on Finance has scheduled a hearing on August 3, 1984, on the provisions of the Tax Reform Act of 1984 (P.L. 98-369) affecting the Federal income tax treatment of interest on deferred payment sales of property.

In the press release announcing the hearings, Subcommittee Chairman Packwood stated that the hearing will focus on the changes to the imputed interest rules of section 483 of the Internal Revenue Code made by the 1984 Act, and on section 1274 of the Code as added by that Act. Section 1274 relates to original issue discount on certain debt obligations issued in exchange for property.

Part I of the pamphlet is an overview. Part II describes the imputed interest and original issue discount rules that were in effect prior to the 1984 Act and the problems that gave rise to the modifications made by the Act. Part III describes the changes made by the 1984 Act. Finally, part IV discusses recently introduced legislation affecting amended section 483 and the new original issue discount provisions.

I. OVERVIEW

The amendments to section 483 and the enactment of new section 1274 in the Tax Reform Act of 1984 (P.L. 98-369) (hereafter referred to as the "1984 Act") were part of a larger legislative effort aimed at reducing the use of abusive tax shelters and at reducing or eliminating the tax benefits of certain transactions that were either unintended or were in excess of what Congress intended when the relevant provisions of law were enacted. One major series of reforms accomplished by the Act was in the so-called "time value of money" area. The time value of money refers to the difference in value between the right to an amount today and the right to the same amount at some time in the future. The value of the right to receive $1 today is greater than the right to receive $1 ten years from today, by the amount that could be earned by investing $1 for ten years.

Prior to the Act, a number of provisions of the Internal Revenue Code ignored, or failed to account properly for, the time value of money. Section 483, which recharacterizes payments of principal and interest in certain transactions where the parties have stated no interest or have stated interest at a rate below a safe-harbor rate fixed by Treasury regulations, was deficient in this respect. Section 483 was enacted in 1963 to require taxpayers involved in deferred payment sales of property to state adequate interest in the transaction, and, thus, to avoid overstating the purchase price of the property. Prior to the Act, section 483 did not require that safe-harbor interest be computed on an economic basis, that is, on a "constant interest" or "yield-to-maturity" basis. Moreover, the safe-harbor rate established by the Treasury Department and modified from time to time in recent years consistently lagged behind actual market rates.

Although the provisions relating to the annual inclusion and deduction of original issue discount on certain debt obligations (the "OID rules," secs. 1232 and 1232A of the Code as in effect prior to the 1984 Act) were amended in 1982 to require economic accruals of interest, these statutory rules by their terms did not apply to obligations issued in exchange for property unless either the debt obligation or the property was traded on an established securities exchange.

Many tax shelters were taking advantage of the limited coverage of the the original issue discount rules and the deficiencies of section 483 to achieve unintended tax benefits. In addition, many transactions in which the principal purpose was not necessarily tax avoidance were producing tax consequences that clearly failed to reflect economic realities, resulting in tax benefits to the parties and a substantial loss of tax revenues to the Federal Government.

The amendments made by the Tax Reform Act of 1984 were intended to remedy this situation by applying the OID rules to many debt-for-property transactions and bringing the rate used to test the adequacy of stated interest in a transaction more in line with market rates. The amendments are generally effective for transactions occurring after December 31, 1984.

II. TREATMENT OF DEFERRED PAYMENT TRANSACTIONS UNDER PRIOR LAW

Under the law prior to the 1984 Act, section 483 and the OID rules addressed two distinct concepts. Section 483 dealt with the measurement of principal and interest in a sale or exchange of property involving deferred payments. The OID rules dealt with the timing of inclusion and deduction of interest on debt instruments.

Measurement of principal and interest

When property is sold and the parties agree to defer payment of all or a portion of the purchase price, a loan transaction has occurred in conjunction with the sale. The seller has lent the purchaser the difference between the purchaser's down payment, if any, and the amount the seller would have accepted for the property if the full amount had been paid at the time of sale. The terms of this purchase money loan may not be expressly stated in the sales contract. For example, the contract may simply require payment of stated amounts on specified dates, with no designation as to which portion of a payment is attributable to principal (i.e., is intended to reimburse the seller for the property) and which portion is attributable to interest (i.e., is intended to compensate the seller for the forebearance of the use of money).

Generally speaking, if the contract specifies a current market rate of interest and requires the purchaser to pay interest on the outstanding loan balance at least annually, there is little or no distortion in the taxation of the parties. The seller's gain on the sale, the purchaser's basis for the property, the seller's interest income, and the purchaser's interest expense for Federal income tax purposes follow the economic substance of the transaction. However, when the contract states an inadequate interest rate or does not require payment of the interest on a current basis, the purchase price of the property has been overstated.[1] What are in economic reality interest payments will have been improperly characterized as payments of sales price or loan principal.

This improper characterization of interest as sales price, although of no economic significance to the parties, may have important tax consequences. If the property sold was a capital asset to the seller, the seller will have transformed interest income (which should be taxable currently as ordinary income) into capital gain

[1] To illustrate how an understatement of the interest element of a transaction overstates the purchase price, assume a sale of property with a value of $100 and an actual market interest rate of 12 percent. Buyer agrees to pay and seller agrees to accept $179 at the end of 5 years (consisting of $100 principal and $79 interest). The parties could, by artificially stating an interest rate on the sale of 9 percent compounded semiannually, fix the principal amount at $115 ($179 discounted to present value at a rate of 9 percent is approximately $115). If recognized for tax purposes, the purported principal amount would overstate the value of the property by $15.

(which is taxable at lower rates and whose taxation is generally deferred until paid). Property that is depreciable in the hands of the purchaser will have an artificially high tax basis, resulting in overstated cost recovery deductions and (if section 38 property is involved) investment tax credits. The cost recovery deductions available to the purchaser under the accelerated cost recovery system (ACRS) may more than offset the reduced interest deductions attributable to the use of a below market rate of interest. In some cases, the present value to the purchaser of the ACRS deductions and investment credit may far exceed the present value of the obligation to pay the seller amounts in the distant future.

Timing of inclusion and deduction of interest

Regardless of the amount of interest payable under a deferred payment sales contract, distortions to the taxation of the parties may occur if the contract does not call for interest to be paid currently. Failure to require payment of interest at least annually may result in a mismatching of the interest income reported by the seller and the corresponding interest expense claimed by the purchaser, where the seller reports income on the cash method and the purchaser on the accrual method. While the accrual method purchaser deducts the interest payable on a current basis, the cash method seller does not include this amount in income until it is received in a subsequent period. The present value to the government of income included by the lender in the subsequent period will be less than the present value of the deductions claimed by the purchaser. As the disparity between the time when the purchaser deducts the interest expense and the time when the seller reports the interest income increases, the cost to the government increases geometrically.

The distortion to the taxation of the parties is magnified if the accrual method purchaser computes its interest deduction using a noneconomic formula, such as straight-line amortization, simple interest, or the "Rule of 78's."[2] This has the effect of overstating the interest accrual in the earlier years of the loan, thus accelerating the purchaser's deductions. An economic accrual formula would take into account the compounding of interest, that is, the fact that more interest economically arises in the later periods because the amount of the debt is increased by the accrued but unpaid interest from earlier periods.

In 1983, the Internal Revenue Service issued a revenue ruling which proscribes the deduction of interest in an amount in excess of the amount of the economic accrual of interest for the taxable year. In Rev. Rul. 83-84, 1983-1 C.B. 9, the Service ruled that the amount of interest attributed to the use of money for a period between payments must be determined by applying the "effective rate of interest" on the loan to the "unpaid balance" of the loan for that period. The unpaid balance of the loan is the amount bor-

[2] The Rule of 78's is a formula for allocating interest over the term of a loan that results in much larger deductions in the early years. To illustrate, in the case of a 30-year loan, interest would be calculated under the Rule of 78's by first taking the sum of the integers from 1 through 30 (i.e., 1+2+3+4....and so on up to 30), or 465. The borrower would accrue 30/465 (or 6.45 percent) of the total interest in the first year, 29/465 (or 6.24 percent) in the second year, and so on until the 30th year when 1/465 (.22 percent) of the interest would be accrued.

rowed plus the interest earned, minus amounts previously paid. The effective rate of interest is a measure of the cost of credit, expressed as a yearly rate, that relates the amount and timing of values received to the amount and timing of payments made; it is thus a reflection of the cost of the amount borrowed for the time it is actually available. The effective rate of interest, which is a uniform rate over the term of the loan and is based on the amount of the loan and the repayment schedule, will produce the true cost of the amount borrowed when applied to the unpaid balance of the loan for a given period. Rev. Rul. 83-84 does not apply to certain short-term, self-amortizing consumer loans that require level payments at regular intervals at least annually.[3]

Although Rev. Rul. 83-84 was consistent with present-law rules for computing original issue discount (under secs. 1232A and 163(e)), generally accepted accounting principles, and sound economic theory, some taxpayers, on advice of counsel, were not complying with its mandate.

Original issue discount rules

Concern over the mismatching of interest income and deductions by lenders and borrowers in loan transactions led to the enactment in 1969 of provisions requiring ratable inclusion in income of original issue discount (OID) by the holder of a debt obligation. OID arises when a borrower agrees to repay a lender more than the amount initially borrowed. The difference between the issue price of an obligation (the amount received by the borrower) and its stated redemption price (the amount that must be repaid to the lender) compensates the lender for the use of its money and thus performs the same function as stated interest.[4]

The 1969 amendments to the Code required OID to be taken into account annually by both lenders and borrowers, regardless of their accounting method. Under these provisions, borrowers were allowed to deduct OID on a straight-line basis over the life of the loan, resulting in interest deductions larger in the earlier years than 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 shortcomings of these rules, further amendments were made to the OID provisions in 1982. Under the 1982 rules, reporting of OID on a constant interest basis is required of both issuers and holders of obligations subject to the OID rules. Thus, OID was required to be allocated over the life of the bond through a series of adjustments to the issue price for each "bond period" (generally, each one-year period beginning on the date of issue of the bond and each anniversary thereof). The adjustment of the issue price for each bond period is determined by multiplying the adjusted issue price (i.e., the issue price as increased by adjustments prior to the beginning of the bond period) by the bond's yield to maturity, and then subtracting the interest payable during the

[3] Rev. Proc. 83-40, 1983-1 C.B. 774.

[4] See *United States* v. *Midland Ross Corporation*, 381 U.S. 54 (1965) (a case that arose under the 1939 Code).

bond period. The adjustment of the issue price for any bond period is the amount of the OID allocated to that bond period.

The OID rules prior to the 1984 Act did not apply to obligations issued by a natural person,[5] obligations not constituting 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 failure to include discount obligations issued for nontraded property where the obligations were themselves not traded resulted from the perceived difficulty in these situations of determining the issue price of the obligation (i.e., the value of the property sold) and, therefore, the amount of the OID implicit in the obligation.[6] If the value of property is not readily ascertainable, the allocation between principal and interest on the obligation becomes uncertain.

Imputed interest on deferred payment sales of nontraded property

Under prior law, parties to a deferred payment transaction involving a sale of property not within the OID rules might nonetheless be subject to the unstated interest rules of section 483. If the parties do not specify a minimum (safe harbor) rate of interest to be paid by the purchaser, section 483 imputes interest at a rate set by the Treasury Department. However, prior to the 1984 Act neither the safe harbor interest rate (also fixed by the Treasury) nor the imputed rate under prior law varied according to the length of time over which deferred payments are made or the maturity of the deferred payment obligation. The current safe harbor rate under section 483 prior to the 1984 Act was 9 percent simple interest; the imputed rate was 10 percent, compounded semiannually.

If interest is imputed under section 483, a portion of each deferred payment is characterized as interest. Under the rules prior to the 1984 Act, the allocation between interest and principal was made on the basis of the relative amounts of the payments, without regard to the time that had elapsed since the sale. Amounts treated as interest under section 483 are included in the income of the lender in the year in which the payment is received (in the case of a cash method taxpayer) or due (in the case of an accrual method taxpayer). The borrower likewise deducts this imputed interest in the year in which payment is made or due.

The simple interest safe harbor rate under prior law did not reflect an economic rate of interest for three reasons. First, although the safe harbor and imputed interest rates changed over the years, they did not keep up with market interest rates. Second, a simple

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[5] Prior to 1982, the OID provisions applied only to corporate and taxable government obligations. The 1982 rules extended these provisions to noncorporate obligations other than those of individuals.

[6] The 1969 Act as originally reported by the House Ways and Means Committee and the Senate Finance Committee included within its scope all transactions involving issuance of a debt obligation for property. A Senate floor amendment added the exception for obligations issued for nontraded property, reflecting concern that the parties to such sales might take inconsistent positions on valuation. See letter from John S. Nolan, Deputy Assistant Secretary of the Treasury (Tax Policy), to Sen. John J. Williams (dated November 28, 1969), 115 Cong. Rec. 36730-36731 (1969). The Conference Report to the Technical Corrections Act of 1982, which repealed the exception to section 1232 for publicly traded obligations issued in a reorganization, acknowledged the continued existence of the mismatching problem in transactions involving nontraded property, and stated that further corrective legislation might be appropriate in the near future if the Treasury Department was unable to deal with the problem administratively. H.R. Rep. No. 97-986, 97th Cong. 2d Sess., p. 21 (1982).

interest computation ignores the compounding of interest on unpaid interest which occurs as an economic matter. For example, a debt obligation bearing a stated rate of 9 percent simple interest payable at the end of 30 years actually bears interest at a rate of 4½ percent on a constant interest basis. The use of a simple interest safe harbor rate may allow taxpayers to avoid imputation of interest under section 483 even though the stated interest is significantly below prevailing market rates. Finally, the use of a single rate for all obligations regardless of the length of maturity fails to reflect the fact that lenders typically demand different returns depending on the term of the loan.

As explained above, understatement of the interest element of a deferred payment transforms what is in reality interest into principal or sales price, with a resulting overstatement of the tax basis of the property purchased. In such a case, the purchaser is able to claim excessive ACRS deductions and investment tax credits. These deductions and credits may have a materially higher present value than the interest deductions that would be available if an economic rate of interest were provided. Tax shelters have taken advantage of the low safe harbor rate provided under section 483 to obtain excessive ACRS deductions and investment credits.

Under the rules prior to the 1984 Act, tax shelters exploited the method of allocating unstated interest among payments by structuring sales transactions so as to accelerate several years' interest charges into the year of the sale. For example, assume property with an established fair market value of $100,000 was sold for $2,500 in cash and two notes, one obligating the purchaser to pay $100,000 six months and one day after the sale, the other obligating the purchaser to pay $100,000 at the end of 30 years.[7] Since the notes have no stated interest, the rules of section 483 prior to the 1984 Act would have imputed interest at a rate of 10 percent, compounded semiannually. Applying this rate, the total unstated interest in the deferred purchase contract was $99,408 (the $200,000 face value of the two notes less $100,592, the sum of their present values). Since the deferred payments are made in two equal installments, the total unstated interest of $99,408 was allocated under prior law one half (i.e., $49,704) to the first note and one half to the second. Thus, the purchaser in this example was arguably [8] entitled to deduct as interest almost one-half the cost of the property in the year of purchase when, economically, virtually all of the imputed interest is paid in the second payment.[9] The major portion of the purchase price was reflected in the payment of the first note, since the payment due in 30 years discounted at a market rate of interest had little present value (slightly more than $3,000 in this example).

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[7] The present value of the cash and the notes, assuming the market rate of interest is 12 percent, would have been approximately $100,000.

[8] It is possible that the rules that restrict deductions for prepaid interest may apply to limit the amount of the interest deduction in this situation.

[9] Although the section 483 rules would have otherwise required the seller to recognize the same ordinary income of $49,704 in the year of payment, the seller might have been able to avoid this result by disposing of the first note within six months of the sale.

III. CHANGES MADE BY THE TAX REFORM ACT OF 1984

A. Extension of OID rules

Overview

The Tax Reform Act of 1984 extended the rules for periodic inclusion and deduction of original issue discount by lenders and borrowers to debt instruments issued for nontraded property and which are themselves not publicly traded, effective for transactions occurring after December 31, 1984. The Act also repealed the exemption for obligations issued by individuals and the exemption from the income accrual requirement for cash method holders of obligations not held as capital assets. As discussed below, exceptions from the rules are provided to ensure that they will not ordinarily apply to routine transactions of individual taxpayers, or to *de minimis* transactions of individuals and others.

If either side of a transaction is publicly traded, the market value of the traded side will determine the issue price of an obligation, as under prior law. Where neither side is traded, however, the issue price and the amount of the OID will be determined by imputing interest to the transaction at a rate higher than the safe-harbor rate in cases where inadequate interest has been provided for. The safe-harbor interest rate used to test the adequacy of interest and the imputed interest rate will be equal to specified percentages of the "applicable Federal rate."

Applicable Federal rate

The safe-harbor rate will be 110 percent of the applicable Federal rate, and the imputed rate 120 percent of that rate. The applicable Federal rate will be a rate based on the average yield for marketable obligations of the United States Government with a comparable maturity. Federal rates will be redetermined by the Secretary at 6-month intervals for 3 categories of obligations: short-term maturity (3 years or less); mid-term maturity (more than 3 years but not more than 9 years); and long-term maturity (more than 9 years). The applicable Federal rate for a transaction will be the rate in effect for that category of maturity as of the first day there is a binding contract for the sale or exchange.[10]

Transactions to which OID rules apply

The adequacy of the interest element in a transaction will be determined by comparing the stated redemption price of the debt instrument at maturity to (1) the principal amount determined by

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[10] Preliminary estimates indicate that the short-, mid-, and long-term safe harbor rates (i.e., 110 percent of the applicable Federal rates) for the period July 1 through December 31 would be approximately 11.25 percent, 12.65 percent, and 13.25 percent, respectively, if the new provision were currently in effect.These figures are based on yields of Government obligations for the 6-month period ended March 31, as required by the statute.

discounting, at a rate equal to 110 percent of the applicable Federal rate, all payments due under the instrument (the "testing amount"), and (2) the principal amount stated in the debt instrument.[11] The obligation will be subject to the OID rules only if either of these amounts is less than the stated redemption price and some or all of the payments under the instrument are due more than 6 months after the sale or exchange. Accordingly, these rules will be inapplicable so long as interest has been provided at a fixed rate at least equal to 110 percent of the applicable Federal rate and is payable unconditionally at the stated rate on an annual basis.[12]

Determination of principal amount

If the safe-harbor rate is not satisfied, the principal amount of the instrument will generally be deemed to be the sum of the present values of all payments due under the instrument using a discount rate equal to 120 percent of the applicable Federal rate. In addition, if the transaction involves a potentially abusive situation, the principal amount of any debt instrument received in exchange for property may be neither more than nor less than the fair market value of the property. A potentially abusive situation includes any transaction involving a "tax shelter" as defined in section 6661(b)(2)(C). It may also include any other situation which 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 of the Treasury by regulations identifies as having a potential for abuse.

Determination of amount of OID

The amount of original issue discount subject to the periodic inclusion and deduction requirements of the OID rules (sec. 1232A of prior law) will be the difference between the issue price and the stated redemption price at maturity. The issue price for this purpose will be the principal amount determined by discounting all payments using a discount rate equal to 120 percent of the applicable Federal rate (limited in accordance with the rule described in the preceding paragraph, where appropriate), or the principal amount payable at maturity if interest has been stated at least at the safe harbor rate. The OID determined under this formula will be treated as interest for all purposes of the Code (e.g., secs. 163, 189, 265, and 543).

Likewise, the allocation between principal and interest resulting from application of the OID rules will determine the principal amount of the loan (and, therefore, the cost of the property). For example, under section 453 (relating to installment sales), the total

[11] In enacting these provisions, the Congress stated that it believed that the use of a safe-harbor rate equal to 110 percent of the applicable Federal rate will roughly correspond to the rate at which a good credit risk could borrow. Consequently, the Congress felt that discounting all payments at this rate should provide a liberal estimate of the principal amount (and, therefore, the value of the property) involved in the transaction. S. Rept.98-108, 98th Cong., 2d Sess, Vol. 1, p. 254, n. 13.

[12] Thus, the OID rules will be inapplicable only in cases where there is a matching of interest income and deductions by the parties. If, for example, the parties provide that interest is payable annually at a rate equal to the applicable Federal rate but accrues at a higher rate (based on a fixed rate of compound interest), the transaction will be within the OID rules and interest will be included and deducted annually at the higher stated rate.

contract price will include debt of the purchaser only to the extent of the principal amount of the debt instrument as determined under these provisions.

Exceptions

Under the 1984 Act, the periodic inclusion and deduction rules will 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), relating to losses on small business stock), or by a partnership whose capital is not in excess of the limits specified in section 1244(c)(3), in exchange for a farm. This exception will apply only if it can be determined at the time of sale that the sales price cannot exceed $1 million. An aggregation provision, to prevent avoidance of the $1 million limitation by splitting a singie transaction into several smaller transactions, requires that sales and exchanges which are part of the same transaction or a series of related transactions be treated as one sale or exchange.

Exceptions are also provided for (1) debt instruments received by an individual as consideration for the sale or exchange of a principal residence (as defined in sec. 1034); (2) cash-method 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; (3) debt instruments received as consideration for the sale or exchange of property if the sum of the payments due under the instrument (whether designated principal or interest) and under any other debt instrument received in the sale, and the fair market value of any other consideration received in the sale, does not exceed $250,000 [redacted]); and (4) sales of land between family members with an aggregate sales price of $500,000 or less. Finally, an exception is provided with respect to a payment attributable to a transfer of a patent that qualifies for capital gain treatment under section 1235, provided such payment is contingent upon the productivity, use, or disposition of the patent. Thus, the exception would not apply in the case of a deferred lump sum amount payable for a patent.

B. Modification of Rules for Making Allocations of Principal and Interest in Other Deferred Payment Transactions

Since the scope of the OID rules is significantly expanded under the 1984 Act, the scope of section 483 under the 1984 Act accordingly is reduced. Section 483 will apply only in the case of deferred payment transactions involving a sale of property which are exempted from the OID rules (e.g., sales of a principal residence; certain sales of farms; transactions involving total payments of $250,000 or less; and that portion of a debt instrument subject to section 483(f) (as redesignated by the Act). The Act revises the interest rates used in section 483 to conform to the new rates used for obligations subject to the OID rules, effective January 1, 1985. Thus, the 483 rules will apply using a compound safe-harbor and imputed interest rates, which will vary according to the maturity of the obligation and will be adjusted at 6-month intervals. Interest income or expense computed on an economic accrual basis will be reported or deducted as under prior law (that is, when payment is made in the case of a cash method taxpayer or due in the case of an accrual method taxpayer).

The revised interest rates provided by the 1984 Act will not apply in the case of any debt instrument arising from the sale or exchange of a principal residence to the extent the purchase price does not exceed $250,000. To the extent the price exceeds this amount, a portion of the debt instrument will be subject to the higher safe harbor and imputed interest rates established by the Act. To the extent the purchase price does not exceed $250,000, the debt instrument will be subject to the revised rules of section 483 except that the safe harbor rate and imputed rate are 9 percent and 10 percent, respectively. Amended section 483 will also not apply to any sale or exchange of farmland. However, if the purchase price of farm exceeds $1 million, the debt instrument will be subject to the 110 percent minimum interest rate and the annual inclusion and deduction requirements of new section 1274. The Act retains the exceptions of prior law under which the section 483 rules do not apply to transactions where the sales price does not exceed $3,000 or to certain amounts constituting annuities under section 72. The Act also retains the rule under which the maximum imputed interest rate applicable to real estate transactions between related parties involving $500,000 or less is 7 percent (sec. 483(f)). The exception for sales of ordinary income property in prior law, however, was eliminated.

The Act also continues the exception under section 483 for the transfer of patents where payment is contingent upon the productivity, use, or disposition of the property transferred. A further exception to the unstated interest rules is provided for cash-method issuers (but not holders) of obligations 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 investment purposes.

The amendments to section 483 are generally effective for transactions occurring after December 31, 1984. However, in the case of sales or exchanges after March 1, 1984, a taxpayer may not rely on the literal terms of section 483 to claim a deduction for interest in amount in excess of that which is properly allocable to the period using a constant interest computation. Therefore, taxpayers in transactions subject to section 483 may no longer compute the portion of a payment constituting interest based on the size of the payment relative to the total payments due under the contract (see discussion at pages 8–9, supra).

IV. RECENTLY INTRODUCED LEGISLATION AFFECTING CODE SECTIONS 483 AND 1274

S. 2815—Senator Symms

On June 28, 1984, Senator Symms introduced a bill (S. 2815) that would repeal the changes made to section 483 by the Tax Reform Act of 1984. Thus, the bill would preserve the system whereby the section 483 safe harbor and imputed interest rates are established by regulation. The effect of the bill would also be to require that in transactions subject to section 483, the interest element of a payment be determined by the ratio of the payment to the total deferred payments due under the contract, as under prior law.

(Similar legislation has been introduced by Mr. Archer in the House of Representatives. H.R. 6021, in addition to repealing the amendments to section 483 made by the Act, would repeal section 1274 as enacted by the Act.)

S. 2815—Senator Melcher

On July 31, 1984, Senator Melcher introduced a bill (S. 2894) which would provide for reduced safe harbor and imputed interest rates for certain sales of residences, farms, or real property used in a trade or business. The maximum safe harbor and imputed interest rates for qualifying transactions would be 9 percent and 10 percent, respectively. Qualifying transactions would include a sale of a principal residence by an individual, a sale of a farm by an individual, estate, testamentary trust, or small business corporation (or by a partnership meeting certain requirements), or a sale by any person of real property used in a trade or business if the sale or exchange occurs in connection with the sale of the business. The maximum rates would apply only to the extent the stated principal amount of the debt instrument issued in the sale or exchange does not exceed qualified limits. The limits would be $250,000 in the case of sales of residences, $1,500,000 in the case of farm sales, and $500,000 in the case of sales of businesses. To the extent the purchase price of the property exceeded the specified limits, the limit would be the specified limit multiplied by a fraction, the numerator of which is the specified limit and the denominator of which is the purchase price.

S. 2894 would exclude a debt instrument arising from the sale of a farm or small business from the application of the provisions of new section 1274 to the extent of that portion of the instrument's principal amount not in excess of the applicable limit under section 483. The provisions of the bill would be effective as if included in the amendments made by the Tax Reform Act of 1984.