# Sales and OID - A Primer

By Charles A. Wry, Jr.

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This outline summarizes generally the original issue discount (or "OID") rules of the Internal Revenue Code (the "Code") and the Treasury Regulations under the Code (the "Regulations") as they apply to sales of non-publicly traded property for non-publicly traded debt instruments. It is not intended to be an exhaustive analysis of the OID rules, particularly as they apply to, among other things, cash loans, publicly traded instruments, instruments issued for publicly traded property, instruments providing for variable payments, instruments providing for alternate payment schedules, convertible or exchangeable instruments, instruments issued as parts of investment units, instruments providing for the payment of points, instruments providing for payments in kind, instruments providing for certain "teaser rates" or "interest holidays," or instruments that have changed hands after their original issuance.

## I. INTRODUCTION

A. Purpose of Rules. The OID rules are set forth in Sections 1272-1275 (and, to a lesser extent, Section 163(e)) of the Code and the Regulations thereunder. If not for the OID rules, cash method lenders and accrual method borrowers might be tempted to "back-load" interest payments so that the lenders include the interest in income only as it is paid while the borrowers deduct the interest as it accrues. In addition, cash method sellers in deferred payment sales might be tempted to avoid characterizing any of their deferred payments as interest to take advantage of capital gain rates and the installment sale rules. Although fairly complicated, the rules are intended simply (i) to identify the portions of the amounts due on a debt instrument that are to be characterized as interest (rather than principal and, in the case of an instrument issued in a sale or exchange of property, amount realized and basis) and (ii) to require that the interest to which the rules apply be taken into account by both the holder and the issuer as it accrues without regard to when it is actually paid.[1]

B. Effect on Seller. From the standpoint of a taxpayer who sells property for a debt instrument, OID is taken into account as ordinary interest income as it accrues and not as part of the amount realized on the sale. In general, any amounts of OID (or interest generally) payable to the seller are backed out before determining the seller's amount realized and in applying the installment sale rules of Code Section 453.

C. Effect on Buyer. From the standpoint of a taxpayer who buys property using a debt instrument, OID (and interest generally) are not part of the cost of the property (for basis or depreciation/amortization purposes). Instead, the buyer deducts the OID under Code Section 163(e) as it accrues (subject to the other provisions of Section 163 and any other deductibility limitations).

[1] Code Section 1275(a)(1) defines a debt instrument as any bond, debenture, note, or certificate or other evidence of indebtedness (with the exception of certain annuity contracts). Regulations Section 1.1275-1(d) adds that a debt instrument is any instrument or contractual arrangement that constitutes indebtedness under general federal income tax principles. Although a discussion of "debt vs. equity" principles is beyond the scope of this outline, one might want to consider whether a debt instrument with equity characteristics is really debt before analyzing it as such. For a case that bifurcated an instrument into debt and equity components, see Farley Realty Corporation v. Commissioner, 279 F.2d 701 (2d Cir. 1960).

## II. EXISTENCE OF OID

A. OID Defined. OID is a debt instrument's "stated redemption price at maturity" (or "SRPM") minus its "issue price" (or "IP"). Thus, OID = SRPM – IP. Code Section 1273(a)(1); Regulations Section 1.1273-1(a).

B. SRPM. A debt instrument's SRPM is the sum of all payments to be made on the instrument other than payments of "qualified stated interest" (or "QSI"). Code Section 1273(a)(2); Regulations Section 1.1273-1(b).

**1. QSI.** QSI is stated interest that is unconditionally payable under the terms of the instrument in cash or property (other than issuer debt instruments), or that will be treated as constructively received under Code Section 451, at least annually at a single fixed rate. Regulations Section 1.1273-1(c)(1)(i). The holder and issuer account for QSI under their regular accounting methods (i.e, it is not OID) under Regulations Section 1.446-2. Under Regulations Section 1.1273-1(c)(1)(ii), the possibility of nonpayment due merely to default, insolvency and the like is ignored in determining whether the instrument is "unconditionally payable."

*a.* For example, suppose that A issues his or her $10,000 note to B to evidence a $10,000 loan by B to A on 1/1/07. Under the terms of the note, A is to make principal payments of $5,000 to B on each of 12/31/08 and 12/31/10. A is also to make interest payments to B of $800 on each of 12/31/07 and 12/31/08, and of $400 on each of 12/31/09 and 12/31/10. Because each interest payment represents the product of 8%, compounded annually, and the outstanding principal balance, all of the interest payments are QSI payments (and accordingly the note has no OID).

i. Varying the example, if an additional $200 of interest is payable to B on each of 12/31/09 and 12/31/10, the additional interest payments are not QSI payments because they do not represent interest payable annually based on a single fixed rate. All of the other $2,400 in interest payments, however, are QSI payments (again, because each of the payments represents the product of 8%, compounded annually, and the outstanding principal balance). The note, therefore, bears $400 of OID (SRPM of $10,400 minus IP of $10,000).

ii. Varying the example again, if A is instead required to make three $1,000 payments of interest on 12/31/08, 12/31/09 and 12/31/10, none of the interest is QSI because it is not paid at least annually at a single fixed rate. All $3,000 of stated interest is therefore OID.

*b.* Under Regulations Section 1.1273-1(c)(1)(iii), interest is payable at a single fixed rate only if it appropriately takes into account the interval between payments.

i. For example, suppose that C issues a $100,000 note to evidence a $100,000 cash loan to him or her on 1/1/07. All of the principal is payable when the note matures on 1/1/11. An interest payment of $8,000 is due on each of 1/1/08 and 1/1/09. After 1/1/09, a quarterly interest payment in the amount of $1,942.65 is due on each 4/1, 7/1, 10/1 and 1/1 until the maturity of the note. The interest payments of $8,000 are based on a rate of 8%, compounded annually ($100,000 x 8% = $8,000). The interest payments of $1,942.65 are based on a rate of 7.77%, compounded quarterly ($100,000 x 7.77%/4 = $1,942.65). Because 8% compounded annually is equivalent to 7.77% compounded quarterly, however, all of the interest payable on the note is QSI, and the note bears no OID. See Regulations Section 1.1273-1(f), example 1.

ii. If an instrument provides for payment intervals that are equal in length throughout

the entire term of the instrument except that the length of the first or final interval is different from the length of the other intervals, however, the first or final interest payment is considered to be made at a fixed rate if the rate on which the payment is based is adjusted in any reasonable manner to take into account the length of the interval.

x. For example, suppose that, on 10/1/07, D issues a $100,000 note to evidence a $100,000 cash loan to him or her on that date. The note matures on 1/1/12, at which time the entire principal amount is due. Under the terms of the note, D is also required to make interest payments of $2,000 on 1/1/08 and of $8,000 on each of 1/1/09, 1/1/10, 1/1/11 and 1/1/12. As the example immediately above illustrates, an 8% rate with annual compounding is the equivalent of a 7.77% rate with quarterly compounding. Here, though, using the 8% rate (divided by four to account for the fact that the initial interval is only one quarter) is a reasonable adjustment. All interest payments on the note, therefore, are QSI payments and the note bears no OID. See Regulations Section 1.1273-1(f), example 2.

C. IP.

**1. Section 1273(b).** Code Section 1273(b) and Regulations Section 1.1273-2 define the IP of a debt instrument that is (i) issued for cash, (ii) issued for publicly traded property or (iii) part of an issue a portion of which is publicly traded.

**2. Section 1274.** In this course, we'll be focusing on non-publicly traded debt instruments that are issued in consideration for the sale or exchange of non-publicly traded property (that is, private sales of non-publicly traded property). The IP of that type of debt instrument is determined under Code Section 1274. Section 1274 does not apply to an instrument, however, if (i) all interest payable on the instrument is QSI, (ii) the stated rate of interest is at least equal to the "test rate," (iii) the instrument is not issued in a "potentially abusive situation" and (iv) no payments designated as points or interest are made to the seller at the time the instrument is issued. Regulations Section 1.1274-1(b). In addition, Code Section 1274(c)(3) provides exceptions to the applicability of Section 1274 for, among other things, certain sales of farms for $1,000,000 or less, sales of principal residences, sales involving total payments of $250,000 or less, and certain sales of patents. In any of those cases, IP is determined under Code Section 1273(b)(4) as the instrument's SRPM (so that the instrument has no OID).

*a.* The IP of a debt instrument to which Section 1274 applies generally depends on whether the instrument bears "adequate stated interest." Code Section 1274(a); Regulations Section 1.1274-2.

i. If the instrument bears adequate stated interest, the IP is the stated principal amount of the instrument (the sum of all payments due under the instrument, excluding stated interest). Code Section 1274(a)(1); Regulations Section 1.1274-2(b)(1).

ii. If the instrument does not bear adequate stated interest, the IP is the "imputed principal amount." Code Section 1274(a)(2); Regulations Section 1.1274-2(b)(2).

*b.* A debt instrument to which Section 1274 applies bears adequate stated interest if its stated principal amount is less than or equal to its imputed principal amount. The instrument does not bear adequate stated interest if its stated principal amount is greater than its imputed principal amount. In general, the stated principal amount is greater than the imputed principal amount when the stated interest rate is less than the test rate. Code Section 1274(c)(2); Regulations Section 1.1274-2(c)(1).

*c.* The imputed principal amount of a debt instrument to which Section 1274 applies is the sum of the present values of all payments (including stated interest) due under the instrument (from the respective dates they become due), determined as of the issue date using a discount rate equal to the test rate. Code Section 1274(b)(1) and (2); Regulations Section 1.1274-2(c)(1).

*d.* Notwithstanding the foregoing rules, the IP of an instrument issued in a "potentially abusive situation" is the fair market value of the property received in exchange for the instrument (minus the fair market value of any property other than the debt instrument provided by the issuer of the instrument in the sale or exchange). Regulations Section 1.1274-2(b)(3).

i. A "potentially abusive situation" includes a sale or exchange of property for a nonrecourse note with less than a 20% cash down payment. Regulations Section 1.1274-3.

*e.* Generally, the test rate applicable to any sale or exchange of property is the lowest "applicable federal rate" in effect during the three-month period ending with the month in which the sale or exchange occurs (or, if lower, during the three-month period ending with the first month in which there is a binding written contract substantially setting forth the terms of the sale or exchange). Regulations Section 1.1274-4(a). The "applicable federal rate" is determined under Code Section 1274(d) based on the term of the instrument. The Internal Revenue Service generally publishes the applicable federal rates for each month during the week or two before the beginning of the month.

i. The test rate applicable to an "installment obligation" is determined by treating its term as its weighted average maturity. Regulations Section 1.1274-4(c)(1). An installment obligation is an instrument that provides for the payment of any amount other than QSI before maturity. Regulations Section 1.1273-1(e)(1).

*f.* The issue date of an instrument to which Section 1274 applies is the date on which it is issued in a sale or exchange. Regulations Section 1.1273-2(d)(2).

D. *De Minimis* Exception. The OID on a debt instrument is treated as zero if it is less than (i) .0025, multiplied by (ii) the SRPM, multiplied by (iii) the number of complete years to maturity from the instrument's issue date. Code Section 1273(a)(3); Regulations Sections 1.1273-1(d)(1) and (2). In that case, the holder treats all stated interest on the instrument as QSI and includes it in income using his or her regular method of accounting. Any *de minimis* OID amounts that are not treated as QSI (because they are not stated as interest) are included by the holder on a ratable basis (as amounts received in retirement of the instrument under Code Section 1271, therefore eligible for reporting at capital gain rates) as stated principal payments are made. Regulations Section 1.1273-1(d)(5)(i), (ii).

**1.** Under Code Section 163(e)(2)(B), the de minimis exception does not exempt the issuer from the OID rules. The issuer treats all stated interest on the instrument as QSI. Regulations Section 1.163-7(b)(1). The de minimis OID that is not treated as QSI may be deducted (subject to the other provisions of Code Section 163) either (i) at maturity, (ii) on a straight-line basis over the term of the instrument or (iii) in proportion to stated interest payments. Regulations Section 1.163-7(b)(2).

**2.** Regulations Section 1.1273-1(d) provides for a number of special de minimis sub-rules. Under one of the sub-rules, if the instrument is an installment obligation, the "weighted average maturity" of the instrument is substituted for the number of complete years to maturity (and if the instrument is a "self-amortizing installment obligation," .00167 may be substituted for .0025).

*a.* A self-amortizing installment obligation is an instrument that provides for equal payments composed of principal and qualified stated interest that are unconditionally due during the entire term of the instrument with no additional required payment at maturity. Regulations Section 1.1273-1(e)(2). Although each payment under the instrument is of the same amount, the portion of each payment that is interest decreases, and the portion of each payment that is principal increases, over the term of the instrument.

E. Example. Suppose that, on 1/1/07, A purchases an office building from B pursuant to a purchase and sale agreement requiring A to pay B $4,000,000 on 12/31/10. No other payments are due from A to B, and there is no stated interest. The test rate, we will assume, is 8%, compounded annually. A's contractual obligation to pay B is a debt instrument. The present value of the $4,000,000 payment due on 12/31/10 discounted back to 1/1/07 at 8%, compounded annually, is $2,940,119, which is the imputed principal amount. Because the stated principal amount of $4,000,000 is greater than the imputed principal amount, the instrument does not bear adequate stated interest, and the imputed principal amount is the IP. The instrument bears OID of $1,059,881 (SRPM of $4,000,000 minus IP of $2,940,119).

**1.** Varying the example, suppose that, of the $4,000,000 due on 12/31/10, $2,940,119 is stated under the terms of the instrument to be principal and $1,059,881 is stated under the terms of the instrument to be interest. Now, the instrument bears adequate stated interest because the stated principal amount is equal to the imputed principal amount. Accordingly, the IP is the stated principal amount of the instrument. The $1,059,881 is still OID, however, because the SRPM of the instrument of $4,000,000 (none of the payments due on the instrument are QSI) exceeds the IP of the instrument by that amount.

**2.** Varying the example again, suppose (i) that the stated principal amount of the instrument is $3,200,000, all of which is payable to B on 12/31/10, and (ii) that A is also required to make annual interest payments to A of $200,000 on each of 12/31/07, 12/31/08, 12/31/09 and 12/31/10. The imputed principal amount of the instrument (i.e., the present value of the payments due B under the instrument discounted from the dates they come due back to 1/1/07 at the test rate) is $3,014,521. Because the stated principal amount of $3,200,000 is greater than the imputed principal amount, the instrument does not bear adequate stated interest, and the imputed principal amount is the IP. The SRPM of the instrument is $3,200,000 (the stated interest payments are QSI). Accordingly, the instrument bears OID of $185,479.

## III. EFFECTS ON AMOUNT REALIZED AND BASIS

A. Amount Realized by Seller. If a taxpayer sells non-publicly traded property entirely or in part for a debt instrument the IP of which is determined under Code Section 1274 (and the taxpayer does not report his or her income from the sale using the installment method of Code Section 453), the portion of the taxpayer's amount realized attributable to the instrument is the IP of the instrument. Regulations Section 1.1001-1(g)(1). See VI.D.1 below, however, if the instrument provides for contingent payments.

B. Basis of Buyer. If a taxpayer buys non-publicly traded property entirely or in part for a debt instrument the IP of which is determined under Code Section 1274, the portion of the taxpayer's cost (i.e., initial basis) attributable to the instrument is the IP of the instrument. Regulations Section 1.1012-1(g)(1). See VI.D.2 below, however, if the instrument provides for contingent payments.

# IV. ACCRUAL OF OID

A. The Steps. In effect, the OID on a debt instrument must be taken into account by both the issuer and the holder of the instrument using the accrual method (without regard to their regular methods of accounting) on the basis of a constant yield to maturity. Under the Regulations, the amount of OID on a debt instrument is assigned to the days of the instrument's term using a four-step analysis.

**1. Determine Yield to Maturity.** The "yield to maturity" (or "YTM") of a debt instrument is the single discount rate that, when used in computing the present value of each of the payments of principal and interest (including QSI) to be made under the instrument, produces a sum of present values equal to the IP of the instrument. Regulations Section 1.1272-1(b)(1)(i).

**2. Determine Accrual Periods.** An "accrual period" is an interval of time over which the accrual of OID is measured. Accrual periods may be of any length and may vary in length over the term of an instrument, so long as each accrual period is no longer than one year and each scheduled payment of principal or interest is due on either the first or last day of an accrual period. OID computations are simplest if accrual periods correspond to the intervals between payment dates under the terms of the instrument. Regulations Section 1.1272-1(b)(1)(ii).

**3. Determine OID Allocable to Each Accrual Period.** The amount of OID allocable to a particular accrual period equals (i) (x) the "adjusted issue price" of the debt instrument as of the beginning of the accrual period multiplied by (y) the YTM of the instrument (appropriately stated to take into account the length of the particular accrual period), minus (ii) the amount of any QSI allocable to the accrual period. Regulations Section 1.1272-1(b)(1)(iii).

*a.* The "adjusted issue price" (or "AIP") of a debt instrument as of the beginning of the first accrual period is the IP of the instrument.

*b.* The AIP of the instrument as of the beginning of any accrual period after the first accrual period is the IP of the instrument,

i. plus the sum of the OID accruals on the instrument for all prior accrual periods,

ii. minus the sum of all payments (other than of QSI) previously made on the instrument (or made on the first day of such accrual period). Regulations Sections 1.1275-1(b), 1.1272-1(b)(4)(iv).

*c.* If an interval between payments of QSI contains more than one accrual period, the amount of QSI payable at the end of the interval (or on the first day of the accrual period immediately following the interval) is allocated on a *pro rata* basis to the accrual periods in the interval, and the AIP at the beginning of each accrual period in the interval is increased by the amount of QSI that has accrued prior to the first day of the accrual period but that is not payable until the end of the interval. Regulations Section 1.1272-1(b)(4)(i).

*d.* The OID allocable to the final accrual period is the difference between the amount payable at maturity (other than of QSI) and the AIP at the beginning of the period. Regulations Section 1.1272-1(b)(4)(ii).

*e.* If all accrual periods are of equal length, except for either an initial shorter accrual period or an initial and a final shorter accrual period, the amount of OID allocable to the initial period may be determined using any reasonable method. Regulations Section 1.1272-1(b)(4)(iii).

4. **Determine Daily Portions of OID.** The OID allocable to an accrual period is then allocated to the days in the accrual period on a ratable basis. A taxpayer who has held the instrument at any time during a taxable year includes in income the sum of the daily portions for days during the year on which he or she held the instrument. Code Section 1272(a)(1); Regulations Section 1.1272-1(b)(1)(iv).

*a.* Under Code Section 163(e) and Regulations Section 1.163-7, the issuer of the instrument is entitled to deduct the daily portions for any year subject to the other provisions of Section 163 and without regard to the *de minimis* rules of Section 1273(a)(3).

B. Example. Returning to the example set forth in II.E above, A and B compute their OID accruals as follows (assuming a 360-day year comprised of twelve 30-day months):

1. **In the basic example and the first variation:**

| AP | BAIP | YTM | QSI | OID |
|---|---|---|---|---|
| 2007 | 2,940,119 | .08 | 0 | 235,210 |
| 2008 | 3,175,329 | .08 | 0 | 254,026 |
| 2009 | 3,429,355 | .08 | 0 | 274,348 |
| 2010 | 3,703,703 | .08 | 0 | 296,297 |
| **Total** | | | | **1,059,881** |

2. **In the second variation:**

| AP | BAIP | YTM | QSI | OID |
|---|---|---|---|---|
| 2007 | 3,014,521 | .08 | 200,000 | 41,162 |
| 2008 | 3,055,683 | .08 | 200,000 | 44,455 |
| 2009 | 3,100,138 | .08 | 200,000 | 48,011 |
| 2010 | 3,148,149 | .08 | 200,000 | 51,851 |
| **Total** | | | | **185,479** |

C. Exceptions. Under Code Section 1272(a), the OID rules do not apply to tax-exempt obligations, U.S. savings bonds, obligations with terms of not more than one year, and certain loans between individuals in amounts not exceeding $10,000.

D. Election by Holder to Treat All Interest as OID. Under Regulations Section 1.1272-3, the holder may elect to include all interest on the debt instrument on the basis of a constant yield under the OID rules.

E. Basis in Debt Instrument Increased by OID. The basis of a debt instrument in the hands of a holder is increased by the amounts of OID included in the holder's income. Regulations Section 1.1272-1(g).

## V. TREATMENT OF PAYMENTS

A. General Ordering Rule. With certain exceptions, a payment on a debt instrument is treated (i) first as a payment of OID to the extent of the OID that has accrued as of the date the payment is due and that has not been allocated to prior payments and (ii) second as a payment of principal. No portion of any payment is treated as prepaid interest. Regulations Section 1.1275-2(a)(1). Subject to the rules of Section 1.1275-2(f) regarding "*pro rata* prepayments," the holder's basis in the debt instrument is decreased by any payment he or she receives on the instrument that is not a QSI payment. Regulations Section 1.1272-1(g).

B. Exceptions. The general ordering rule described in (A) does not apply to a payment of QSI, a payment of deductible points, a late charge or a pro rata prepayment. Regulations Section 1.1275-2(a)(2).

**1. Pro Rata Prepayment Defined.** A pro rata prepayment is a payment on a debt instrument made prior to maturity that (i) is not made pursuant to the instrument's payment schedule and (ii) results in a substantially pro rata reduction of each payment remaining to be made. Regulations Section 1.1275-2(f)(2).

**2. Treatment of Pro Rata Prepayment.** A pro rata prepayment is treated as a payment in retirement of a portion of the debt instrument. Accordingly, the holder may recognize gain or loss on the prepayment calculated by treating the original debt instrument as two debt instruments, one of which is retired and the other of which remains outstanding. The AIP, adjusted basis and accrued but unpaid OID as of the time immediately before the prepayment are allocated between the two instruments based on the portion of the instrument treated as being retired. Regulations Section 1.1275-2(f)(1).

## VI. CONTINGENT PAYMENT DEBT INSTRUMENTS

A. In General. In general, the rules applicable to debt instruments providing for contingent payments (other than contingencies covered by Regulations Section 1.1272-1(c), which we're not going to discuss) are set forth in Regulations Section 1.1275-4. Under the Regulations, a payment is not contingent merely because of the possibility of nonpayment due to insolvency, default and the like.

B. Section 1.1275-4(b). Regulations Section 1.1275-4(b) provides the rules applicable to a contingent payment debt instrument that is (i) issued for cash, (ii) issued for publicly traded property or (iii) part of an issue a portion of which is publicly traded.

C. Section 1.1275-4(c). Again, we'll be focusing on non-publicly traded debt instruments issued in consideration for the sale or exchange of non-publicly traded property. The rules applicable to a contingent payment debt instrument of that type are set forth in Regulations Section 1.1275-4(c).

**1. Bifurcation of Instrument.** The Regulations bifurcate the instrument into its noncontingent and contingent components. Regulations Section 1.1275-4(c)(2).

*a.* The noncontingent payments, if any, are treated as a separate debt instrument with an IP equal to the IP of the overall instrument (so that the OID rules are applied to the noncontingent payments as if they were a separate instrument). No interest payments on the separate instrument are QSI, however, and the de minimis rules do not apply. Regulations Section 1.1275-4(c)(3).

i. The IP of the overall debt instrument is the lesser of (x) the instrument's noncontingent principal payments or (y) the sum of the present values of the noncontingent payments (discounted from the respective dates they come due back to the date of the sale or exchange at the test rate). If the instrument is issued in a potentially abusive situation, however, the IP is the fair market value of the noncontingent payments. Regulations Section 1.1274-2(g).

*b.* Each contingent payment is discounted from the date it is made back to the date of the sale or exchange at the test rate applicable to the overall instrument, determined as if the term of the overall instrument began on the date of the sale or exchange and ended on the date of the payment (provided that the test rate is the stated interest rate if the payment consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate). The present value of the payment is treated as principal. The excess of the amount of the payment over the present value of the payment is treated as interest (includible by the holder and deductible by the issuer, subject to any applicable limitations, in the year in which the payment is made). Regulations Section 1.1275-4(c)(4).

i. Notwithstanding the foregoing, if a contingent payment comes due more than six months after it becomes fixed, the issuer is deemed to have issued to the holder, on the date the payment becomes fixed, a new debt instrument with (x) a stated principal amount equal to the amount that becomes fixed and (y) an IP equal to the amount that becomes fixed discounted from the date the payment comes due back to the date the payment becomes fixed at the test rate applicable to the overall instrument (substituting the date the payment comes due for the date the payment is made). The IP of the deemed instrument is treated as principal or interest under the rules described in (b) above as if it were paid in cash to the holder on the date the payment becomes fixed. Regulations Section 1.1275-4(c)(4)(iii).

**2. Basis Different from AIP.** If a taxpayer sells non-publicly traded property entirely or in part for a debt instrument subject to Regulations Section 1.1275-4(c), does not report his or her income from the sale using the installment method under Code Section 453, and has a basis in the debt instrument that differs from the instrument's AIP, he or she must allocate his or her basis in the instrument (i) first to the noncontingent component to the extent of its AIP (and to any deemed instruments arising from any contingent payments becoming fixed to the extent of their respective AIPs) and (ii) thereafter to the contingent component. The portion of any contingent payment that is treated as principal reduces the taxpayer's basis in the contingent component. Once the taxpayer's basis in the contingent component has been reduced to zero, any remaining contingent principal payments are treated as gain from the sale or exchange of the instrument. Any remaining basis left in the contingent component after the final contingent payment has been made increases the taxpayer's adjusted basis in the noncontingent component or, if there are no noncontingent payments remaining to be made, is treated as a loss from the sale or exchange of the instrument. Regulations Section 1.1275-4(c)(5).

**3. Sale, Exchange or Retirement.** The amount received on the sale, exchange or retirement of a debt instrument subject to Regulations Section 1.1275-4(c) is allocated (i) first to the noncontingent component to the extent of its AIP (and to any deemed instruments arising from any contingent payments becoming fixed to the extent of their respective AIPs) and (ii) thereafter to the contingent component. The amount allocated to the noncontingent component (or any deemed instrument arising from any contingent payment becoming fixed) is treated as an amount realized from the sale, exchange or retirement of the noncontingent component (or deemed instrument). The amount allocated to the contingent component is treated as a contingent payment made on the date of the sale, exchange or retirement (and as principal or interest under Regulations Section 1.1275-4(c)(4)). Regulations Section 1.1275-4(c)(6).

D. Amount Realized and Basis.

**1. Amount Realized by Seller.** If a taxpayer sells non-publicly traded property entirely or in part for a debt instrument subject to Regulations Section 1.1275-4(c), the rules described in III.A above are inapplicable. Instead, if the taxpayer does not report his or her income using the installment method under Code Section 453, the portion of his or her amount realized attributable to the debt instrument is (i) the IP of the overall debt instrument as determined under Regulations Section 1.1274-2(g) plus (ii) the fair market value of the contingent payments. Regulations Section 1.1001-1(g)(2).

*a.* Section 1.1001-1(g)(2) does not apply, however, if the fair market value of the contingent payments is not reasonably ascertainable. The Regulations caution that the fair market value will not be reasonably ascertainable only in rare and extraordinary cases.

**2. Basis of Buyer.** The portion of the buyer's initial basis attributable to the debt instrument, on the other hand, is the instrument's issue price without regard to the contingent payments. The buyer's basis is then increased by the portion of any contingent payment that is treated as principal when the payment is made (or, in the case of any payment that comes due more than six months after it becomes fixed, when it becomes fixed). Regulations Sections 1.1012-1(g)(1), 1.1275-4(c)(7), example 1.

E. Example. Returning to the second variation of the example in II.E above, suppose that, in addition to the $200,000 stated interest payments he or she must make to B at the close of each year during the term of the instrument (and the $3,200,000 principal payment he or she must make at maturity), A is also obligated to pay B, on 12/31 of each year through and including 2010, a percentage of the gross rentals he or she receives from leasing the building during the year then ending. Assume that, under that provision, A makes additional payments to B of $200,000 on 12/31/07, $250,000 on 12/31/08, $260,000 on 12/31/09 and $290,000 on 12/31/10. Assume also that the short-term test rate (i.e., the rate applicable to instruments issued on the date of the sale having terms not longer than three years) is 7.5%.

**1. The Noncontingent Payments.** The noncontingent payments are treated as a separate debt instrument with an SRPM of $4,000,000 (because no interest payments are QSI under Regulations Section 1.1275-4(c)(3)), an IP of $3,014,521, and a YTM of 8%, compounded annually. The OID accruals with respect to the noncontingent payments are as follows:[2]

| AP | BAIP | YTM | OID |
|---|---|---|---|
| 2007 | 3,014,521 | .08 | 241,162 |
| 2008 | 3,055,683 | .08 | 244,455 |
| 2009 | 3,100,138 | .08 | 248,011 |
| 2010 | 3,148,149 | .08 | 251,851 |
| **Total** | | | **985,479** |

[2] Note that the $200,000 annual stated interest payments are not separately included or deducted. Instead, they are applied in reduction of accrued but unpaid OID under the payment ordering rules.

**2. The Contingent Payments.** To determine the portions of the contingent payments that are principal and interest, each payment must be discounted back to 1/1/07 from the date it is made. The test rate applicable to the first three payments is 7.5%, compounded annually. The test rate applicable to the final payment is 8%, compounded annually. The present value of each payment is principal, while the excess of each payment over its present value is interest that must be taken into account by both A and B for the year of the payment. The payments are broken out as follows:

| Date | Amount | Principal | Interest |
|---|---|---|---|
| 12/31/07 | 200,000 | 186,047 | 13,953 |
| 12/31/08 | 250,000 | 216,333 | 33,667 |
| 12/31/09 | 260,000 | 209,290 | 50,710 |
| 12/31/10 | 290,000 | 213,159 | 76,841 |
| **Totals** | **1,000,000** | **824,829** | **175,171** |

**3. Amount Realized and Basis.**

*a.* If B elects not to report his or her gain from the sale on the installment method under Code Section 453, his or her amount realized on the sale is $3,014,521 plus the fair market value, as of the date of the sale, of the contingent payments.

*b.* A's initial basis in the office building is $3,014,521. His or her basis is then increased by the portions of the contingent payments treated as principal as he or she makes the payments to B.

## VII. SPECIAL RULES

A. Aggregation of Debt Instruments. Under Regulations Section 1.1275-2(c), separate debt instruments issued by a single issuer to a single holder in connection with a single transaction or related series of transactions are generally treated as a single debt instrument.

B. Anti-Abuse Rule. Under Regulations Section 1.1275-2(g), the Commissioner may apply or depart from the OID rules as necessary to prevent taxpayers from structuring debt instruments or transactions to achieve results that are unreasonable in light of the purposes of the rules.

## VIII. SECTION 483

Code Section 483 applies to certain of the property transactions excepted from the OID rules. Unlike the OID rules, it does not require that interest be taken into account before it is paid. Instead, it recharacterizes portions of payments on debt instruments lacking "adequate stated interest" as interest. The amounts recharacterized as interest are taken into account by the holder and the issuer under their regular methods of accounting.

## IX. SECTION 1274A

A. Cap on Discount Rate. Code Sections 1274A(a) and (b) cap the discount rate used in applying the OID rules and Section 483 with respect to any "qualified debt instrument." A qualified debt instrument is a debt instrument issued in consideration for the sale or exchange of certain property if the stated principal amount is less than $2,800,000 (adjusted for inflation).

B. Cash Method. Under Code Section 1274A(c), the borrower and lender may elect to report interest income on a qualified debt instrument with a stated principal amount not exceeding $2,000,000 (adjusted for inflation) and to which the OID rules would otherwise have applied using the cash method and applying the principles of Section 483. The election may not be made, however, if the lender uses the accrual method or is a dealer in the property sold or exchanged.

*This article is not intended to constitute legal or tax advice and cannot be used for the purpose of avoiding penalties under the Internal Revenue Code or promoting, marketing or recommending any transaction or matter addressed herein.*