Bulletin No. 1996–28
July 8, 1996

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 96–34, page 4.

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for July 1996.

T.D. 8674, page 7.

Final regulations under section 1275 of the Code relate to the tax treatment of debt instruments that provide for one or more contingent payments.

IA–292–84, page 38.

Proposed regulations under section 467 of the Code relate to the treatment of rent and interest under certain agreements for the lease of tangible property. A public hearing will be held on September 25, 1996.

TAX CONVENTIONS

Page 36.

The bilateral agreements between the U.S. and Luxembourg, providing for the reciprocal tax exemption of income from the international operation of ships and/or aircraft, are set forth.

ADMINISTRATIVE

Announcement 96–62, page 53.

Taxpayers can use the current Forms 706, 706–A, 706–NA, 709, 709–A, and their instructions until the new revisions are available.

Finding Lists begin on page 59.
Announcement of Disbarments and Suspensions begins on page 56.

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is ''protecting the revenue.'' The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes an index for the matters published during the preceding month. These monthly indexes are cumulated on a quarterly and semiannual basis, and are published in the first Bulletin of the succeeding quarterly and semi-annual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted federal long-term rate is set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, on this page.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for July 1996.

Rev. Rul. 96–34

This revenue ruling provides various prescribed rates for federal income tax purposes for July 1996 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the blended annual rate for purposes of section 7872.

REV. RUL. 96–34 TABLE 1

Applicable Federal Rates (AFR) for July 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	6.04%	5.95%	5.91%	5.88%
110% AFR	6.66%	6.55%	6.50%	6.46%
120% AFR	7.27%	7.14%	7.08%	7.04%
130% AFR	7.89%	7.74%	7.67%	7.62%
Mid-Term				
AFR	6.74%	6.63%	6.58%	6.54%
110% AFR	7.42%	7.29%	7.22%	7.18%
120% AFR	8.12%	7.96%	7.88%	7.83%
130% AFR	8.81%	8.62%	8.53%	8.47%
150% AFR	10.20%	9.95%	9.83%	9.75%
175% AFR	11.94%	11.60%	11.44%	11.33%
Long-Term				
AFR	7.12%	7.00%	6.94%	6.90%
110% AFR	7.85%	7.70%	7.63%	7.58%
120% AFR	8.58%	8.40%	8.31%	8.26%
130% AFR	9.31%	9.10%	9.00%	8.93%

REV. RUL. 96–34 TABLE 2

Adjusted AFR for July 1996

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.88%	3.84%	3.82%	3.81%
Mid-term adjusted AFR	4.83%	4.77%	4.74%	4.72%
Long-term adjusted AFR	5.78%	5.70%	5.66%	5.63%

REV. RUL. 96–34 TABLE 3

Rates Under Section 382 for July 1996

Adjusted federal long-term rate for the current month	5.78%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.78%

REV. RUL. 96–34 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for July 1996

Appropriate percentage for the 70% present value low-income housing credit	8.63%
Appropriate percentage for the 30% present value low-income housing credit	3.70%

REV. RUL. 96–34 TABLE 5

Rate Under Section 7520 for July 1996

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	8.2%

REV. RUL. 96–34 TABLE 6

Blended Annual Rate for 1996

Section 7872(e)(2) blended annual rate for 1996	5.77%

Section 1275.—Other Definitions and Special Rules

26 CFR 1.1275–4: Contingent payment debt instruments.

T.D. 8674

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Debt Instruments with Original Issue Discount; Contingent Payments; Anti-Abuse Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the tax treatment of debt instruments that provide for one or more contingent payments. This document also contains final regulations that treat a debt instrument and a related hedge as an integrated transaction. In addition, this document contains amendments to the original issue discount regulations, and finalizes the anti-abuse rule relating to those regulations. The final regulations in this document provide needed guidance to holders and issuers of contingent payment debt instruments.

DATES: Except as noted below, the regulations are effective August 13, 1996. The amendments to §1.1275–5 are effective June 14, 1996, except for paragraphs (a)(6), (b)(2), and (c)(1), which are effective August 13, 1996. The removal of §1.483–2T is effective June 14, 1996. The removal of §1.1275–2T is effective August 13, 1996.

For dates of applicability of these regulations, see Effective Dates under Supplementary Information.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations (other than §1.1275–6), William E. Blanchard, (202) 622-3950, or Jeffrey W. Maddrey, (202) 622-3940; or concerning §1.1275–6, Michael S. Novey, (202) 622-3900 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1450. Responses to these collections of information are required to determine a taxpayer's interest income or deductions on a contingent payment debt instrument.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent/recordkeeper varies from .3 hours to .5 hours, depending on individual circumstances, with an estimated average of .47 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to the collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 1275(d) of the Internal Revenue Code (Code) grants the Secretary the authority to prescribe regulations under the original issue discount (OID) provisions of the Code (sections 163(e) and 1271 through 1275), including regulations relating to debt instruments that provide for contingent payments. On February 2, 1994, the IRS published final OID regulations in the **Federal Register** (59 FR 4799 [TD 8517, 1994–1 C.B. 38]). However, the final OID regulations did not contain rules for contingent payment debt instruments.

On December 16, 1994, the IRS published a notice of proposed rulemaking in the **Federal Register** (59 FR 62884 [FI–59–91, 1995–1 C.B. 894]) relating to the tax treatment of debt instruments that provide for one or more contingent payments. The notice also contained proposed amendments to the regulations under sections 483 (relating to unstated interest), 1001 (relating to the amount realized on a sale, exchange, or other disposition of property), 1272 (relating to the accrual of OID), 1274 (relating to debt instruments issued for nonpublicly traded property), and 1275(c) (relating to OID information reporting requirements), and to §1.1275–5 (relating to variable rate debt instruments). In addition, the notice contained proposed regulations relating to the integration of a contingent payment or variable rate debt instrument with a related hedge. The notice withdrew the proposed regulations relating to contingent payment debt instruments that were previously published in the **Federal Register** on April 8, 1986 (51 FR 12087), and February 28, 1991 (56 FR 8308).

On March 16, 1995, the IRS held a public hearing on the proposed regulations. In addition, the IRS received a number of written comments on the proposed regulations. The proposed regulations, with certain changes to respond to comments, are adopted as final regulations. In addition, certain clarifying and conforming amendments are made to the OID regulations that were published in the **Federal Register** on February 2, 1994. The comments and significant changes are discussed below.

Explanation of Provisions

Section 1.1275–4 Contingent payment debt instruments

A. *Noncontingent bond method*

Under the noncontingent bond method in the proposed regulations, a taxpayer computes interest accruals on a contingent payment debt instrument by setting a payment schedule as of the issue date and applying the OID rules to the payment schedule. The payment schedule consists of all fixed payments on the debt instrument and a projected amount for each contingent payment. For market-based contingencies (*i.e.,* contingencies for which price quotes are readily available), the projected amount is the forward price of the contingency. For other contingencies, the issuer first determines a reasonable yield for the debt instrument and then sets projected amounts equal to the relative expected payments on the

contingencies so that the payment schedule produces the reasonable yield. These rules were designed to produce a yield similar to the yield the issuer would obtain on a fixed rate debt instrument.

Commentators suggested that the regulations could be simplified if they used the same basic methodology for both market-based and non-market-based contingencies. In addition, commentators suggested that forward price quotes would be variable or manipulable and that taxpayers will set more appropriate payment schedules if they first determine yield and then set the payment schedule to fit the yield.

The final regulations adopt these suggestions and generally conform the treatment of debt instruments that provide for either market-based or non-market-based contingent payments. Thus, for any contingent payment debt instrument subject to the noncontingent bond method, a taxpayer first determines the yield on the instrument and then sets the payment schedule to fit the yield. The yield is determined by the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to the contingent payment debt instrument (the comparable yield). Relevant terms and conditions include the level of subordination, term, timing of payments, and general market conditions. For example, if a hedge is available such that the issuer or holder could integrate the debt instrument and the hedge into a synthetic fixed-rate debt instrument under the rules of §1.1275–6, the comparable yield is the yield that the synthetic fixed-rate debt instrument would have. If a §1.1275–6 hedge (or the substantial equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In all cases, the yield must be a reasonable yield for the issuer and may not be less than the applicable Federal rate (AFR).

Once the comparable yield is determined, the payment schedule is set to produce the comparable yield. The final regulations retain the general approach of the proposed regulations in determining the payment schedule. Thus, for market-based payments, the projected payment is the forward price of the payment. For non-market-based payments, the projected payment is the expected amount of the payment as of the issue date.

Commentators were concerned that a taxpayer could overstate the yield on a contingent payment debt instrument and, therefore, claim excess interest deductions during the term of the instrument. They were particularly concerned about a long-term debt instrument that has non-market-based payments because the taxpayer's determination would be hard to verify and any excess interest deductions would not be recaptured for a long time.

The final regulations address this concern by providing that the comparable yield for a debt instrument is presumed to be the AFR if the instrument provides for a non-market-based payment and is part of an issue that is marketed or sold in substantial part to tax-exempt investors or other investors for whom the treatment of the debt instrument is not expected to have a substantial effect on their U.S. tax liability. A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield that is higher than the AFR. Appraisals and other valuations of nonpublicly traded property cannot be used to overcome the presumption, nor can references to general market rates. An issuer may, for example, overcome the presumption by showing that recently issued similar debt instruments of the issuer trade at a price that reflects a specific yield.

One commentator suggested that the use of the term *projected payment schedule* caused securities law problems because the issuer could be seen as making representations to the holder about the expected payments. The comparable yield and projected payment schedule determined under these regulations are for tax purposes only and are not assurances by the issuer with respect to the payments. The final regulations retain the term *projected payment schedule*, but an issuer may use a different term to describe the payment schedule (*e.g.*, payment schedule determined under §1.1275–4) if the language used by the issuer is clear.

Under the proposed regulations, projected payments rather than actual payments are used to determine the adjusted issue price of a debt instrument, the holder's basis in a debt instrument, and the amount of any contingent payment treated as made on the scheduled retirement of a debt instrument. One commentator questioned the use of projected payments to make these determinations. The approach in the proposed regulations is appropriate, however, because a positive or negative adjustment is used to take into account the difference between the actual amount and the projected amount of a contingent payment. This difference would be counted twice if the adjusted issue price, the holder's basis, and the amount deemed paid on retirement were based on the actual amount rather than the projected amount of a contingent payment. Thus, the approach used in the proposed regulations is retained in the final regulations.

B. *Tax-exempt obligations*

In response to comments, the rules contained in §1.1275–4(d) relating to tax-exempt contingent payment obligations have been revised. Under the proposed regulations, tax-exempt obligations are generally subject to the noncontingent bond method, with the following modifications: (1) The yield on which interest accruals are based may not exceed the greater of the yield on the obligation, determined without regard to the non-market-based contingent payments, and the tax-exempt AFR that applies to the obligation; (2) Positive adjustments are treated as gain from the sale or exchange of the obligation rather than as interest; and (3) Negative adjustments reduce the amount of tax-exempt interest, and, therefore, are generally not taken into account as deductible losses. These modifications to the noncontingent bond method for tax-exempt obligations were added because the IRS and Treasury believe that when a property right is embedded in a tax-exempt obligation it is generally inappropriate to treat payments on the right as interest on an obligation of a state or political subdivision.

Several commentators suggested that the proposed regulations relating to tax-exempt obligations are overly restrictive. These commentators questioned the reason for limiting the rate of accrual to the tax-exempt AFR and characterizing positive adjustments as taxable gain rather than interest. They also questioned the fairness of treating negative adjustments as nondeductible adjustments to tax-exempt interest when positive adjustments are treated

as taxable gain. Some of the commentators suggested that, at a minimum, the interest limitations should not apply to contingent obligations that pay interest based on interest rate formulas that reflect the cost of funds rather than changes in the value of embedded property rights. Finally, commentators noted that programs involving municipal refinancings of real estate projects (for example, low-income multi-family housing projects) would be jeopardized by the proposed regulations because payments on tax-exempt obligations issued to finance these projects are in certain cases contingent in part on the revenues or appreciation in value of the project.

The IRS and Treasury continue to believe that gain from a property right should not be recharacterized as tax-exempt interest merely because the property right is embedded in a tax-exempt obligation. The IRS and Treasury nevertheless recognize that certain types of traditional tax-exempt financings should not be subject to the interest limitations of the proposed regulations (*e.g.,* financings on which interest is computed in a manner that relates to the cost of funds). Accordingly, §1.1275–4(d) has been revised to include a category of tax-exempt obligations that will be subject to the noncontingent bond method without the tax-exempt interest limitations contained in the proposed regulations. This category of tax-exempt obligations includes (1) obligations that would qualify as variable rate debt instruments (VRDIs) except for the failure to meet certain of the technical requirements of the VRDI definition (such as the cap and floor limitations, or the requirement that interest be paid or compounded at least annually), and (2) certain obligations issued to refinance an obligation, the proceeds of which were used to finance a project.

For other tax-exempt obligations, the interest restrictions of the proposed regulations are adopted in final form. Section 1.1275–4(d) has been revised, however, to provide that a negative adjustment is treated as a taxable loss from the sale or exchange of the obligation, rather than as a nondeductible adjustment to tax-exempt interest.

C. *Prepaid tuition plans*

A number of commentators asked whether contracts issued under state-sponsored prepaid tuition plans are subject to §1.1275–4. Although the terms of the contracts vary, the contracts generally are issued pursuant to a plan created by a state to enable the participants in the plan to save for post-secondary education for themselves or other designated beneficiaries. In addition, the plans generally provide protection against increases in the costs of higher education or otherwise subsidize these costs, often by providing for contingent payments that are linked to the future costs of post-secondary education.

The commentators argue that §1.1275–4 does not apply to the contracts because the contracts are not debt instruments for federal income tax purposes. In addition, the commentators argue that, even if the contracts are debt instruments, the noncontingent bond method would be unduly burdensome and inappropriate for contracts of this type.

The final regulations under §1.1275–4 do not affect the treatment of contracts issued pursuant to state-sponsored prepaid tuition plans, whether or not the contracts are debt instruments. The final regulations, like the proposed regulations, only apply to debt instruments. Thus, the final regulations do not apply to contracts issued pursuant to a plan created by a state to enable participants to save for post-secondary education if the contracts are not debt instruments. In addition, the final regulations provide an exception for any debt instrument issued pursuant to a state-sponsored prepaid tuition plan.

This exception applies to a contract issued pursuant to a plan or arrangement if: The plan or arrangement is created by a state statute; the plan or arrangement has a primary objective of enabling the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and the contingencies under the contract are related to such purpose. These characteristics are intended to describe all existing state-sponsored prepaid tuition plans. Therefore, the final regulations do not change the tax treatment of a contract issued pursuant to these plans. As a result, if the contract is a debt instrument, the contingent payments on the contract are not taken into account by an individual until the payments are made.

The exception in the final regulations is intended to apply only to the existing state-sponsored prepaid tuition plans and to any future plans that are substantially similar to the existing plans. In addition, no inference is intended as to whether contracts issued by any state-sponsored prepaid tuition plan are debt instruments.

D. *Debt instruments subject to section 1274*

The proposed regulations provide a method for contingent payment debt instruments not subject to the noncontingent bond method (*i.e.,* a non-publicly traded debt instrument issued in a sale or exchange of nonpublicly traded property). Under the method, a debt instrument's noncontingent payments are treated as a separate debt instrument, which is generally taxed under the rules for noncontingent debt instruments. The debt instrument's contingent payments are taken into account when made. A portion of each contingent payment is treated as principal, based on the amount determined by discounting the payment at the AFR from the payment date to the issue date, and the remainder is treated as interest. Special rules are provided if a contingent payment becomes fixed more than 6 months before it is due.

The final regulations generally adopt the method in the proposed regulations. In addition, the final regulations contain rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (*e.g.,* a subsequent holder).

E. *Inflation-indexed bonds*

The Treasury recently announced that it was considering issuing bonds indexed to inflation (61 FR 25164). Depending on their ultimate structure, the noncontingent bond method might be inappropriate for these bonds. If the Treasury issues these bonds, the Treasury and IRS may issue regulations to provide a simplified tax treatment for the bonds. The treatment would require current accrual of the inflation component.

Other amendments to the OID regulations

A. *Alternative payment schedules under §1.1272–1(c)*

Section 1.1272–1(c) provides rules to determine the yield and maturity of

certain debt instruments that provide for one or more alternative payment schedules applicable upon the occurrence of a contingency (or contingencies), provided that the timing and amounts of the payments that comprise each payment schedule are known as of the issue date. Under these rules, the yield and maturity of a debt instrument are generally determined by assuming that the payments will be made under the payment schedule most likely to occur (based on all the facts and circumstances as of the issue date). Special rules are provided for unconditional options and mandatory sinking funds.

The general rules in §1.1272–1(c) produce a reasonable result when a debt instrument has one stated payment schedule that is very likely to occur and one or more alternative payment schedules that are unlikely to occur. In this case, adherence to the stated payment schedule will result in accruals on the debt instrument that reasonably reflect the expected return on the instrument. The rules can lead to unreasonable results, however, if a debt instrument provides for a stated payment schedule and one or more alternative payment schedules that differ significantly and that have a comparable likelihood of occurring. In this case, the accruals based on the payment schedule identified as most likely to occur could differ significantly from the expected return on the debt instrument, which would reflect all the payment schedules and their relative probabilities of occurrence.

Because the general rules of §1.1272–1(c) could produce unreasonable results, these rules have been modified. Under the final regulations, if a single payment schedule is significantly more likely than not to occur, the yield and maturity of the debt instrument are calculated based on that payment schedule. As a result, any other debt instrument that provides for an alternative payment schedule (other than because of an unconditional option or mandatory sinking fund) will generally be subject to the rules in §1.1275–4 for contingent payment debt instruments. The final regulations generally retain the rules for mandatory sinking funds and unconditional options.

B. *Remote and incidental contingencies*

The proposed regulations provide that a payment subject to a remote or incidental contingency is not considered a contingent payment for purposes of §1.1275–4. In response to a comment, the rule relating to remote and incidental contingencies has been broadened, through the addition of new §1.1275–2(h), to provide that remote and incidental contingencies are generally ignored for purposes of sections 163(e) (other than section 163(e)(5)) and 1271 through 1275 and the regulations thereunder. Thus, for example, if an otherwise fixed payment debt instrument provides for an additional payment that will be made upon the occurrence of a contingency and there is a remote likelihood that the contingency will occur, the contingent payment is ignored for purposes of computing OID accruals on the instrument. If the contingency occurs, however, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as reissued. Therefore, OID on the debt instrument is redetermined.

C. *Definition of qualified stated interest*

The addition of the rules for remote or incidental contingencies and the changes to the rules for alternative payment schedules allow simplification of the definition of qualified stated interest. Under §1.1273–1(c), as published in the **Federal Register** on February 2, 1994, qualified stated interest must be unconditionally payable in cash or property at least annually at a single fixed rate. Interest is unconditionally payable only if late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment is expected to be penalized or reasonable remedies exist to compel payment.

This definition of unconditionally payable can be read to conflict with the alternative payment schedule rules. For example, if a debt instrument has two alternative payment schedules, one schedule can be stated as the required payment schedule and the other schedule can be stated as a penalty if the required payments are not made. The required payments might then be treated as unconditionally payable and, therefore, as being qualified stated interest even if they would not be qualified stated interest if treated under the alternative payment schedule rules. Under this treatment, if a payment is not made, the reissuance rules of the alternative payment schedule regime do not apply. Holders can thus argue that no OID would accrue with respect to the debt instrument even though OID would accrue if the instrument were treated as having an alternative payment schedule and holders fully expect any unmade payment to be made in the future.

The remote or incidental rules in §1.1275–2(h) provide a better mechanism for determining whether a payment is qualified stated interest and determining the treatment if no payment is made. Thus, the final regulations modify the definition of unconditionally payable so that interest is unconditionally payable only if reasonable legal remedies exist to compel payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment remote. If the payment is not made (other than because of insolvency, default, or similar circumstances), the final regulations require a deemed reissuance for OID purposes, which ensures that OID will accrue. This approach should simplify the treatment of many debt instruments and yet ensure that OID accrues in appropriate circumstances.

D. *OID anti-abuse rule*

On February 2, 1994, the IRS published in the **Federal Register** temporary and proposed regulations that contained an anti-abuse rule for purposes of the OID regulations (§1.1275–2T (59 FR 4831); §1.1275–2(g) (59 FR 4878)). Under the anti-abuse rule, the Commissioner can apply or depart from the regulations under section 163(e) or sections 1271 through 1275 as necessary to achieve a reasonable result if a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result under the regulations that is unreasonable in light of the applicable statutes. This rule is adopted as a final regulation with some clarifying changes and the addition of an example to illustrate its application to certain contingent payment debt instruments.

E. *Determination of issue price under section 1274*

Under the proposed regulations, the issue price of a contingent payment

debt instrument that is subject to section 1274 (*i.e.,* a debt instrument issued in exchange for nonpublicly traded property) is determined without taking into account the instrument's contingent payments. Thus, the issue price of the debt instrument (and the buyer's initial basis in the property) is limited to an amount determined by taking into account only the noncontingent payments. The buyer's basis in the property, however, is increased by the amount of a contingent payment treated as principal. This approach was adopted primarily because it is inappropriate to allow a buyer a basis in property that reflects anticipated contingent payments that are uncertain in amount. In addition, this approach limits the ability of the buyer to overstate interest deductions over the term of the debt instrument. The approach of the proposed regulations has been adopted in the final regulations for taxable debt instruments subject to section 1274. See §1.1274–2(g).

It is not appropriate, however, to apply this approach to tax-exempt contingent payment obligations subject to section 1274. Because the present value of projected contingent payments generally is not included in the issue price of a taxable debt instrument subject to section 1274, the instrument is accounted for under §1.1275–4(c). This regime is not appropriate for tax-exempt obligations because it does not distinguish between tax-exempt interest and gain attributable to an embedded property right. Thus, in order to permit tax-exempt obligations to be subject to the noncontingent bond method under §1.1275–4(b), the final regulations provide special rules to determine the issue price of a tax-exempt contingent payment obligation subject to section 1274.

Under these rules, the issue price of a tax-exempt contingent payment obligation subject to section 1274 is equal to the fair market value of the obligation on the issue date (or, in the case of an obligation that provides for interest-based or revenue-based payments, the greater of the obligation's fair market value or stated principal amount). In addition, the obligation is subject to the rules of §1.1275–4(d) (the noncontingent bond method for tax-exempt contingent payment obligations) rather than §1.1275–4(c). However, to ensure that the buyer's basis is the same as if the buyer had issued a taxable debt instrument, the final regulations limit the buyer's basis to the present value of the fixed payments.

§1.1275–6 Integration rules

Commentators generally approved of the integration rules in the proposed regulations, and those rules are adopted with only two significant changes.

First, the final regulations allow (but do not require) the integration of a hedge with a fixed rate debt instrument. For example, a taxpayer may integrate a fixed rate debt instrument and a swap into a VRDI. Although the hedging transaction regulations (§1.446–4) cover many of these transactions, the integration rules provide more certain treatment. The final regulations, however, do not allow the Commissioner to integrate a hedge with either a fixed rate debt instrument or a VRDI that provides for interest at a qualified floating rate. In these cases, treating the hedge and the debt instrument separately is a longstanding rule that generally clearly reflects income.

Second, in limited circumstances, the final regulations allow a hedge to be entered into prior to the date the taxpayer issues or acquires the debt instrument. In these circumstances, however, the taxpayer must identify the hedge as part of an integrated transaction on the day the hedge is entered into by the taxpayer. Under the final regulations, if the hedging transaction has not yet had any cash flows (including amounts paid to enter into or purchase the hedge), the integration rules work appropriately so that any built-in gain or loss on the hedge at the time of integration is included over the term of the synthetic debt instrument. Thus, the final regulations put no restriction on the time the hedging transaction has to be entered into in this case. If there have been cash flows on the hedge, the final regulations require the hedge to be entered into no earlier than a date that is substantially contemporaneous with the date on which the debt instrument is acquired. This approach should allow commercially reasonable transactions to be integrated without the need to create complex rules to determine the treatment of prior cash flows on the hedging transaction.

The rules for remote and incidental contingencies in §1.1275–2(h) apply for purposes of the integration rules. Thus, if there is an incidental mismatch between a §1.1275–6 hedge and a qualifying debt instrument, a taxpayer may still integrate the hedge and the instrument. The mismatch is dealt with according to the rules for incidental contingencies.

The final regulations also clarify the timing of income, deductions, gains, and losses from a hedge of a contingent payment debt instrument not subject to integration. Under §1.446–4, the income, deductions, gains, and losses must match the income, deductions, gains, and losses from the debt instrument. The final regulations clarify that gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to §1.1275–4(c) is taken into account when the contingent payment is taken into account under §1.1275–4(c). This treatment does not allow the taxpayer to change the timing of the income, deductions, gains, and losses from the debt instrument.

Effective Dates

In general, the final regulations apply to debt instruments issued on or after August 13, 1996. Section 1.1275–6 applies to a qualifying debt instrument issued on or after August 13, 1996. Section 1.1275–6 also applies to a qualifying debt instrument acquired by the taxpayer on or after August 13, 1996, if the qualifying debt instrument is a fixed rate debt instrument or a VRDI or if the qualifying debt instrument and the §1.1275–6 hedge are acquired by the taxpayer substantially contemporaneously. Except as otherwise provided in the regulations, the changes to §1.1275–5 apply to debt instruments issued on or after April 4, 1994.

Debt instruments issued before the effective date of the final regulations

For a contingent payment debt instrument issued before August 13, 1996, a taxpayer may use any reasonable method to account for the debt instrument, including a method that would have been required under the proposed regulations when the debt instrument was issued. However, unless §1.1275–6 applies to the debt instrument, integration is not a reasonable method to account for the instrument.

Consent to change accounting method

The Commissioner grants consent for a taxpayer to change its method of

accounting to follow the final regulations in this document. This consent is granted, however, only for a change for the first taxable year in which the taxpayer must account for a debt instrument under the final regulations. The change is made on a cut-off basis (*i.e.,* the new method only applies to debt instruments issued on or after August 13, 1996). Therefore, no items of income or deduction are omitted or duplicated, and no adjustment under section 481 is allowed.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

Several persons from the Office of Chief Counsel and the Treasury Department, including Andrew C. Kittler, formerly of the Office of the Assistant Chief Counsel (Financial Institutions and Products), participated in developing these regulations.

* * * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

Part 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for §1.1275–2T and adding two entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.483–4 also issued under 26 U.S.C. 483(f). * * *
Section 1.1275–6 also issued under 26 U.S.C. 1275(d). * * *

Par. 2. Section 1.163–7 is amended by adding a sentence at the end of paragraph (a) to read as follows:

§1.163–7 Deduction for OID on certain debt instruments.

(a) * * * To determine the amount of interest (OID) that is deductible each year on a debt instrument that provides for contingent payments, see §1.1275–4.

* * * * * *

Par. 3. Section 1.446–4 is amended by:

1. Redesignating paragraphs (a)(2)(ii) and (a)(2)(iii) as paragraphs (a)(2)(iii) and (a)(2)(iv), respectively.
2. Adding a new paragraph (a)(2)(ii).
3. Adding a sentence at the end of paragraph (e)(4).

The additions read as follows:

§1.446–4 Hedging transactions.

(a) * * *

(2) * * *

(ii) An integrated transaction subject to §1.1275–6;

* * * * * *

(e) * * *

(4) * * * Similarly, gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to §1.1275–4(c) (a contingent payment debt instrument issued for nonpublicly traded property) is taken into account when the contingent payment is taken into account under §1.1275–4(c).

* * * * * *

§1.483–2T [Removed]

Par. 4. Section 1.483–2T is removed effective June 14, 1996.

Par. 5. Section 1.483–4 is added to read as follows:

§1.483–4 Contingent payments.

(a) *In general.* This section applies to a contract for the sale or exchange of property (the overall contract) if the contract provides for one or more contingent payments and the contract is subject to section 483. This section applies even if the contract provides for adequate stated interest under §1.483–2. If this section applies to a contract, interest under the contract is generally computed and accounted for using rules similar to those that would apply if the contract were a debt instrument subject to §1.1275–4(c). Consequently, all noncontingent payments under the overall contract are treated as if made under a separate contract, and interest accruals on this separate contract are computed under rules similar to those contained in §1.1275–4(c)(3). Each contingent payment under the overall contract is characterized as principal and interest under rules similar to those contained in §1.1275–4(c)(4). However, any interest, or amount treated as interest, on a contract subject to this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (*e.g.,* an accrual method or the cash receipts and disbursements method).

(b) *Examples*. The following examples illustrate the provisions of paragraph (a) of this section.

Example 1. Deferred payment sale with contingent interest—(i) *Facts*. On December 31, 1996, A sells depreciable personal property to B. As consideration for the sale, B issues to A a debt instrument with a maturity date of December 31, 2001. The debt instrument provides for a principal payment of $200,000 on the maturity date, and a payment of interest on December 31 of each year, beginning in 1997, equal to a percentage of the total gross income derived from the property in that year. However, the total interest payable on the debt instrument over its entire term is limited to a maximum of $50,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually, and the mid-term applicable Federal rate is 5 percent, compounded annually.

(ii) *Treatment of noncontingent payment as separate contract*. Each payment of interest is a contingent payment. Accordingly, under paragraph (a) of this section, for purposes of applying section 483 to the debt instrument, the right to the noncontingent payment of $200,000 is treated as a separate contract. The amount of unstated interest on this separate contract is equal to $43,295, which is the amount by which the payment ($200,000) exceeds the present value of the payment ($156,705), calculated using the test rate of 5 percent, compounded annually. The $200,000 payment is thus treated as consisting of a payment of interest of $43,295 and a payment of principal of $156,705. The interest is includible in A's gross income, and deductible by B, under their respective methods of accounting.

(iii) *Treatment of contingent payments*. Assume that the amount of the contingent payment that is paid on December 31, 1997, is $20,000. Under paragraph (a) of this section, the $20,000 payment is treated as a payment of principal of $19,231 (the present value, as of the date of sale,

of the $20,000 payment, calculated using a test rate equal to 4 percent, compounded annually) and a payment of interest of $769. The $769 interest payment is includible in A's gross income, and deductible by B, in their respective taxable years in which the payment occurs. The amount treated as principal gives B additional basis in the property on December 31, 1997. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 4 percent, compounded annually, for the payments made on December 31, 1998, and December 31, 1999, and a test rate of 5 percent, compounded annually, for the payments made on December 31, 2000, and December 31, 2001.

Example 2. Contingent stock payout—(i) *Facts*. M Corporation and N Corporation each owns one-half of the stock of O Corporation. On December 31, 1996, pursuant to a reorganization qualifying under section 368(a)(1)(B), M acquires the one-half interest of O held by N in exchange for 30,000 shares of M voting stock and a non-assignable right to receive up to 10,000 additional shares of M's voting stock during the next 3 years, provided the net profits of O exceed certain amounts specified in the contract. No interest is provided for in the contract. No additional shares are received in 1997 or in 1998. In 1999, the annual earnings of O exceed the specified amount, and, on December 31, 1999, an additional 3,000 M voting shares are transferred to N. The fair market value of the 3,000 shares on December 31, 1999, is $300,000. Assume that on December 31, 1996, the short-term applicable Federal rate is 4 percent, compounded annually. M and N are calendar year taxpayers.

(ii) *Allocation of interest*. Section 1274 does not apply to the right to receive the additional shares because the right is not a debt instrument for federal income tax purposes. As a result, the transfer of the 3,000 M voting shares to N is a deferred payment subject to section 483 and a portion of the shares is treated as unstated interest under that section. The amount of interest allocable to the shares is equal to the excess of $300,000 (the fair market value of the shares on December 31, 1999) over $266,699 (the present value of $300,000, determined by discounting the payment at the test rate of 4 percent, compounded annually, from December 31, 1999, to December 31, 1996). As a result, the amount of interest allocable to the payment of the shares is $33,301 ($300,000 – $266,699). Both M and N take the interest into account in 1999.

(c) *Effective date*. This section applies to sales and exchanges that occur on or after August 13, 1996.

Par. 6. Section 1.1001–1 is amended by revising paragraph (g) to read as follows:

§1.1001–1 Computation of gain or loss.

* * * * *

(g) *Debt instruments issued in exchange for property*—(1) *In general*. If a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1273–2 or §1.1274–2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the amount realized attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain debt instruments that provide for contingent payments*—(i) *In general*. Paragraph (g)(1) of this section does not apply to a debt instrument subject to either §1.483–4 or §1.1275–4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(ii) *Special rule to determine amount realized*. If a debt instrument subject to §1.1275–4(c) is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1274–2(g), increased by the fair market value of the contingent payments payable on the debt instrument. If a debt instrument subject to §1.483–4 is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is its stated principal amount, reduced by any unstated interest (as determined under section 483), and increased by the fair market value of the contingent payments payable on the debt instrument. This paragraph (g)(2)(ii), however, does not apply to a debt instrument if the fair market value of the contingent payments is not reasonably ascertainable. Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable.

(3) *Coordination with section 453*. If a debt instrument is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, this paragraph (g) applies rather than §15a.453–1(d)(2) to determine the taxpayer's amount realized attributable to the debt instrument.

(4) *Effective date*. This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

Par. 7. Section 1.1012–1 is amended by revising paragraph (g) to read as follows:

§1.1012–1 Basis of property.

* * * * *

(g) *Debt instruments issued in exchange for property*—(1) *In general*. For purposes of paragraph (a) of this section, if a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1273–2 or §1.1274–2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the cost of the property attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain tax-exempt obligations*. This paragraph (g)(2) applies to a tax-exempt obligation (as defined in section 1275(a)(3)) that is issued in exchange for property and that has an issue price determined under §1.1274–2(j) (concerning tax-exempt contingent payment obligations and certain tax-exempt variable rate debt instruments subject to section 1274). Notwithstanding paragraph (g)(1) of this section, if this paragraph (g)(2) applies to a tax-exempt obligation, for purposes of paragraph (a) of this section, the cost of the property that is attributable to the obligation is the sum of the present values of the noncontingent payments (as determined under §1.1274–2(c)).

(3) *Effective date*. This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

Par. 8. Section 1.1271–0(b) is amended by:

1. Revising the entries for paragraphs (c)(2), (c)(3), (c)(4), and (d) of §1.1272–1.

2. Adding an entry for paragraph (c)(7) of §1.1272–1.

3. Revising the entry for paragraph (g) and adding entries for paragraphs (i) and (j) of §1.1274–2.

4. Removing the language ''[Reserved]'' from the entry for paragraph (g) and adding entries for paragraphs (g), (h), (i), and (j) of §1.1275–2.

5. Removing the entries for §1.1275–2T.

6. Adding entries for §1.1275–4.

7. Adding entries for paragraphs (a)(5) and (a)(6) of §1.1275–5.

8. Revising the entries for paragraphs (c)(1) and (c)(5) of §1.1275–5.

9. Adding entries for §1.1275–6.

The revisions and additions read as follows:

§1.1271–0 Original issue discount; effective date; table of contents.

* * * * * * *

(b) * * *

* * * * * * *

§1.1272–1 Current inclusion of OID in income.

* * * * * * *

(c) * * *
  (2) Payment schedule that is significantly more likely than not to occur.
  (3) Mandatory sinking fund provision.
  (4) Consistency rule. [Reserved]

* * * * * * *

  (7) Effective date.
(d) Certain debt instruments that provide for a fixed yield.

* * * * * * *

§1.1274–2 Issue price of debt instruments to which section 1274 applies.

* * * * * * *

(g) Treatment of contingent payment debt instruments.

* * * * * * *

(i) [Reserved]
(j) Special rules for tax-exempt obligations.
  (1) Certain variable rate debt instruments.
  (2) Contingent payment debt instruments.
  (3) Effective date.

* * * * * * *

§1.1275–2 Special rules relating to debt instruments.

* * * * * * *

(g) Anti-abuse rule.
  (1) In general.
  (2) Unreasonable result.
  (3) Examples.
  (4) Effective date.
(h) Remote and incidental contingencies.
  (1) In general.
  (2) Remote contingencies.
  (3) Incidental contingencies.
  (4) Aggregation rule.
  (5) Consistency rule.
  (6) Subsequent adjustments.
  (7) Effective date.
(i) [Reserved]
(j) Treatment of certain modifications.

* * * * * * *

§1.1275–4 Contingent payment debt instruments.

(a) Applicability.
  (1) In general.
  (2) Exceptions.
  (3) Insolvency and default.
  (4) Convertible debt instruments.
  (5) Remote and incidental contingencies.
(b) Noncontingent bond method.
  (1) Applicability.
  (2) In general.
  (3) Description of method.
  (4) Comparable yield and projected payment schedule.
  (5) Qualified stated interest.
  (6) Adjustments.
  (7) Adjusted issue price, adjusted basis, and retirement.
  (8) Character on sale, exchange, or retirement.
  (9) Operating rules.
(c) Method for debt instruments not subject to the noncontingent bond method.
  (1) Applicability.
  (2) Separation into components.
  (3) Treatment of noncontingent payments.
  (4) Treatment of contingent payments.
  (5) Basis different from adjusted issue price.
  (6) Treatment of a holder on sale, exchange, or retirement.
  (7) Examples.
(d) Rules for tax-exempt obligations.
  (1) In general.
  (2) Certain tax-exempt obligations with interest-based or revenue-based payments
  (3) All other tax-exempt obligations.
  (4) Basis different from adjusted issue price.
(e) Amounts treated as interest under this section.
(f) Effective date.

§1.1275–5 Variable rate debt instruments.

(a) * * *
  (5) No contingent principal payments.
  (6) Special rule for debt instruments issued for nonpublicly traded property.

* * * * * * *

(c) * * *
  (1) Definition.

* * * * * * *

  (5) Tax-exempt obligations.

* * * * * * *

§1.1275–6 Integration of qualifying debt instruments.

(a) In general.
(b) Definitions.
  (1) Qualifying debt instrument.
  (2) Section 1.1275–6 hedge.
  (3) Financial instrument.
  (4) Synthetic debt instrument.
(c) Integrated transaction.
  (1) Integration by taxpayer.
  (2) Integration by Commissioner.
(d) Special rules for legging into and legging out of an integrated transaction.
  (1) Legging into.
  (2) Legging out.
(e) Identification requirements.
(f) Taxation of integrated transactions.
  (1) General rule.
  (2) Issue date.
  (3) Term.
  (4) Issue price.
  (5) Adjusted issue price.
  (6) Qualified stated interest.
  (7) Stated redemption price at maturity.
  (8) Source of interest income and allocation of expense.
  (9) Effectively connected income.
  (10) Not a short-term obligation.
  (11) Special rules in the event of integration by the Commissioner.
  (12) Retention of separate transaction rules for certain purposes.
  (13) Coordination with consolidated return rules.
(g) Predecessors and successors.
(h) Examples.
(i) [Reserved]
(j) Effective date.

Par. 9. Section 1.1272–1 is amended by:

1. Revising paragraphs (b)(2)(ii), (c), and (d).

2. Adding a sentence at the end of paragraph (f)(2).

3. Removing the language ''determining yield and maturity'' from the first sentence of paragraph (j) *Example 5* (iii) and adding the language ''sections 1272 and 1273'' in its place.

4. Removing the language ''determining yield and maturity'' from the second sentence of paragraph (j) *Example 7* (v) and adding the language ''sections 1272 and 1273'' in its place.

The revisions and addition read as follows:

§1.1272–1 Current inclusion of OID in income.

* * * * * *

(b) * * *

(2) * * *

(ii) A debt instrument that provides for contingent payments, other than a debt instrument described in paragraph (c) or (d) of this section or except as provided in §1.1275–4; or

* * * * * *

(c) *Yield and maturity of certain debt instruments subject to contingencies*—(1) *Applicability*. This paragraph (c) provides rules to determine the yield and maturity of certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the issue date and the debt instrument is subject to paragraph (c)(2), (3), or (5) of this section. A debt instrument does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See §1.1275–4 for the treatment of a debt instrument that provides for a contingency that is not described in this paragraph (c). See §1.1273–1(c) to determine whether stated interest on a debt instrument subject to this paragraph (c) is qualified stated interest.

(2) *Payment schedule that is significantly more likely than not to occur*. If, based on all the facts and circumstances as of the issue date, a single payment schedule for a debt instrument, including the stated payment schedule, is significantly more likely than not to occur, the yield and maturity of the debt instrument are computed based on this payment schedule.

(3) *Mandatory sinking fund provision*. Notwithstanding paragraph (c)(2) of this section, if a debt instrument is subject to a mandatory sinking fund provision, the provision is ignored for purposes of computing the yield and maturity of the debt instrument if the use and terms of the provision meet reasonable commercial standards. For purposes of the preceding sentence, a mandatory sinking fund provision is a provision that meets the following requirements:

(i) The provision requires the issuer to redeem a certain amount of debt instruments in an issue prior to maturity.

(ii) The debt instruments actually redeemed are chosen by lot or purchased by the issuer either in the open market or pursuant to an offer made to all holders (with any proration determined by lot).

(iii) On the issue date, the specific debt instruments that will be redeemed on any date prior to maturity cannot be identified.

(4) *Consistency rule*. [Reserved]

(5) *Treatment of certain options*. Notwithstanding paragraphs (c)(2) and (3) of this section, the rules of this paragraph (c)(5) determine the yield and maturity of a debt instrument that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the term of the debt instrument, that, if exercised, require payments to be made on the debt instrument under an alternative payment schedule or schedules (*e.g.,* an option to extend or an option to call a debt instrument at a fixed premium). Under this paragraph (c)(5), an issuer is deemed to exercise or not exercise an option or combination of options in a manner that minimizes the yield on the debt instrument, and a holder is deemed to exercise or not exercise an option or combination of options in a manner that maximizes the yield on the debt instrument. If both the issuer and the holder have options, the rules of this paragraph (c)(5) are applied to the options in the order that they may be exercised. See paragraph (j) *Example 5* through *Example 8* of this section.

(6) *Subsequent adjustments*. If a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(5) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to this paragraph (c) (a change in circumstances), then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to its adjusted issue price on that date. See paragraph (j) *Example 5* and *Example 7* of this section. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in §1.1275–2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the debt instrument, which may result in gain or loss to the holder. See paragraph (j) *Example 6* and *Example 8* of this section.

(7) *Effective date*. This paragraph (c) applies to debt instruments issued on or after August 13, 1996.

(d) *Certain debt instruments that provide for a fixed yield*. If a debt instrument provides for one or more contingent payments but all possible payment schedules under the terms of the instrument result in the same fixed yield, the yield of the debt instrument is the fixed yield. For example, the yield of a debt instrument with principal payments that are fixed in total amount but that are uncertain as to time (such as a demand loan) is the stated interest rate if the issue price of the instrument is equal to the stated principal amount and interest is paid or compounded at a fixed rate over the entire term of the instrument. This paragraph (d) applies to debt instruments issued on or after August 13, 1996.

* * * * * *

(f) * * *

(2) * * * For purposes of the preceding sentence, the last possible date that the debt instrument could be outstanding is determined without regard to §1.1275–2(h) (relating to payments subject to remote or incidental contingencies).

* * * * * *

Par. 10. Section 1.1273–1 is amended by:

1. Removing the language ''principal payments uncertain as to time'' in the fourth sentence of paragraph (a) and adding the language ''a fixed yield'' in its place.

2. Revising paragraph (c)(1)(ii).

3. Revising paragraph (f) *Example 4*.

The revisions read as follows:

§1.1273–1 Definition of OID.

* * * * * *

(c) * * * (1) * * *

(ii) *Unconditionally payable.* Interest is unconditionally payable only if reasonable legal remedies exist to compel timely payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment a remote contingency (within the meaning of §1.1275–2(h)). For purposes of the preceding sentence, remedies or other terms and conditions are not taken into account if the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions. For purposes of determining whether interest is unconditionally payable, the possibility of nonpayment due to default, insolvency, or similar circumstances, or due to the exercise of a conversion option described in §1.1272–1(e) is ignored. This paragraph (c)(1)(ii) applies to debt instruments issued on or after August 13, 1996.

* * * * * *

(f) * * *

Example 4. Qualified stated interest on a debt instrument that is subject to an option—(i) *Facts.* On January 1, 1997, A issues, for $100,000, a 10-year debt instrument that provides for a $100,000 principal payment at maturity and for annual interest payments of $10,000. Under the terms of the debt instrument, A has the option, exercisable on January 1, 2002, to lower the annual interest payments to $8,000. In addition, the debt instrument gives the holder an unconditional right to put the debt instrument back to A, exercisable on January 1, 2002, in return for $100,000.

(ii) *Amount of qualified stated interest.* Under paragraph (c)(2) of this section, the debt instrument provides for qualified stated interest to the extent of the lowest fixed rate at which qualified stated interest would be payable under any payment schedule. If the payment schedule determined by assuming that the issuer's option will be exercised and the put option will not be exercised were treated as the debt instrument's sole payment schedule, only $8,000 of each annual interest payment would be qualified stated interest. Under any other payment schedule, the debt instrument would provide for annual qualified stated interest payments of $10,000. Accordingly, only $8,000 of each annual interest payment is qualified stated interest. Any excess of each annual interest payment over $8,000 is included in the debt instrument's stated redemption price at maturity.

* * * * * *

Par. 11. Section 1.1274–2 is amended by:

1. Removing the language ''§1.1272–1(c)(3)(ii)'' from paragraph (e) and adding the language ''§1.1272–1(c)(3)'' in its place.

2. Revising paragraph (g).

3. Adding and reserving paragraph (i) and adding paragraph (j).

The revisions and additions read as follows:

§1.1274–2 Issue price of debt instruments to which section 1274 applies.

* * * * * *

(g) *Treatment of contingent payment debt instruments.* Notwithstanding paragraph (b) of this section, if a debt instrument subject to section 1274 provides for one or more contingent payments, the issue price of the debt instrument is the lesser of the instrument's noncontingent principal payments and the sum of the present values of the noncontingent payments (as determined under paragraph (c) of this section). However, if the debt instrument is issued in a potentially abusive situation, the issue price of the debt instrument is the fair market value of the noncontingent payments. For additional rules relating to a debt instrument that provides for one or more contingent payments, see §1.1275–4. This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

* * * * * *

(i) [Reserved]

(j) *Special rules for tax-exempt obligations*—(1) *Certain variable rate debt instruments.* Notwithstanding paragraph (b) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is a variable rate debt instrument (within the meaning of §1.1275–5) that pays interest at an objective rate and is subject to section 1274, the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(2) *Contingent payment debt instruments.* Notwithstanding paragraphs (b) and (g) of this section, if a tax-exempt obligation (as defined in section 1275(a)(3)) is subject to section 1274 and §1.1275–4, the issue price of the obligation is the fair market value of the obligation. However, in the case of a tax-exempt obligation that is subject to §1.1275–4(d)(2) (an obligation that provides for interest-based or revenue-based payments), the issue price of the obligation is the greater of the obligation's fair market value and its stated principal amount.

(3) *Effective date.* This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

Par. 12. Section 1.1275–2 is amended by adding the text of paragraph (g), adding paragraph (h), adding and reserving paragraph (i), and adding paragraph (j) to read as follows:

§1.1275–2 Special rules relating to debt instruments.

* * * * * *

(g) *Anti-abuse rule*—(1) *In general.* If a principal purpose in structuring a debt instrument or engaging in a transaction is to achieve a result that is unreasonable in light of the purposes of section 163(e), sections 1271 through 1275, or any related section of the Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (g) applies to a debt instrument that provides for a contingent payment, the Commissioner can treat the contingency as if it were a separate position.

(2) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. In the case of a contingent payment debt instrument, another significant fact is whether the result is obtainable without the application of §1.1275–4 and any related provisions (*e.g.,* if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (g).

Example 1. A issues a current-pay, increasing-rate note that provides for an early call option. Although the option is deemed exercised on the call date under §1.1272–1(c)(5), the option is not expected to be exercised by A. In addition, a

principal purpose of including the option in the terms of the note is to limit the amount of interest income includible by the holder in the period prior to the call date by virtue of the option rules in §1.1272–1(c)(5). Moreover, the application of the option rules is expected to substantially reduce the present value of the holder's tax liability. Based on these facts, the application of §1.1272–1(c)(5) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the regulations (in whole or in part) to the note without regard to §1.1272–1(c)(5).

Example 2. C, a foreign corporation not subject to U.S. taxation, issues to a U.S. holder a debt instrument that provides for a contingent payment. The debt instrument is issued for cash and is subject to the noncontingent bond method in §1.1275–4(b). Six months after issuance, C and the holder modify the debt instrument so that there is a deemed reissuance of the instrument under section 1001. The new debt instrument is subject to the rules of §1.1275–4(c) rather than §1.1275–4(b). The application of §1.1275–4(c) is expected to substantially reduce the present value of the holder's tax liability as compared to the application of §1.1275–4(b). In addition, a principal purpose of the modification is to substantially reduce the present value of the holder's tax liability through the application of §1.1275–4(c). Based on these facts, the application of §1.1275–4(c) produces an unreasonable result. Therefore, under this paragraph (g), the Commissioner can apply the noncontingent bond method to the modified debt instrument.

Example 3. D issues a convertible debt instrument rather than an economically equivalent investment unit consisting of a debt instrument and a warrant. The convertible debt instrument is issued at par and provides for annual payments of interest. D issues the convertible debt instrument rather than the investment unit so that the debt instrument would not have OID. See §1.1273–2(j). In general, this is a reasonable result in light of the purposes of the applicable statutes. Therefore, the Commissioner generally will not use the authority under this paragraph (g) to depart from the application of §1.1273-2(j) in this case.

(4) *Effective date*. This paragraph (g) applies to debt instruments issued on or after August 13, 1996.

(h) *Remote and incidental contingencies*—(1) *In general*. This paragraph (h) applies to a debt instrument if one or more payments on the instrument are subject to either a remote or incidental contingency. Whether a contingency is remote or incidental is determined as of the issue date of the debt instrument, including any date there is a deemed reissuance of the debt instrument under paragraph (h)(6)(ii) or (j) of this section or §1.1272–1(c)(6). Except as otherwise provided, the treatment of the contingency under this paragraph (h) applies for all purposes of sections 163(e) (other than section 163(e)(5)) and 1271 through 1275 and the regulations thereunder. For purposes of this paragraph (h), the possibility of impairment of a payment by insolvency, default, or similar circumstances is not a contingency.

(2) *Remote contingencies*. A contingency is remote if there is a remote likelihood either that the contingency will occur or that the contingency will not occur. If there is a remote likelihood that the contingency will occur, it is assumed that the contingency will not occur. If there is a remote likelihood that the contingency will not occur, it is assumed that the contingency will occur.

(3) *Incidental contingencies*—(i) *Contingency relating to amount*. A contingency relating to the amount of a payment is incidental if, under all reasonably expected market conditions, the potential amount of the payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(i), the payment is ignored until the payment is made. However, see paragraph (h)(6)(i)(B) of this section for the treatment of the debt instrument if a change in circumstances occurs prior to the date the payment is made.

(ii) *Contingency relating to time*. A contingency relating to the timing of a payment is incidental if, under all reasonably expected market conditions, the potential difference in the timing of the payment (from the earliest date to the latest date) is insignificant. If a payment on a debt instrument is subject to an incidental contingency described in this paragraph (h)(3)(ii), the payment is treated as made on the earliest date that the payment could be made pursuant to the contingency. If the payment is not made on this date, a taxpayer makes appropriate adjustments to take into account the delay in payment. However, see paragraph (h)(6)(i)(C) of this section for the treatment of the debt instrument if the delay is not insignificant.

(4) *Aggregation rule*. For purposes of paragraph (h)(2) of this section, if a debt instrument provides for multiple contingencies each of which has a remote likelihood of occurring but, when all of the contingencies are considered together, there is a greater than remote likelihood that at least one of the contingencies will occur, none of the contingencies is treated as a remote contingency. For purposes of paragraph (h)(3)(i) of this section, if a debt instrument provides for multiple contingencies each of which is incidental but the potential total amount of all of the payments subject to the contingencies is not, under reasonably expected market conditions, insignificant relative to the total expected amount of the remaining payments on the debt instrument, none of the contingencies is treated as incidental.

(5) *Consistency rule*. For purposes of paragraphs (h)(2) and (3) of this section, the issuer's determination that a contingency is either remote or incidental is binding on all holders. However, the issuer's determination is not binding on a holder that explicitly discloses that its determination is different from the issuer's determination. Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument. See §1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(6) *Subsequent adjustments*—(i) *Applicability*. This paragraph (h)(6) applies to a debt instrument when there is a change in circumstances. For purposes of the preceding sentence, there is a change in circumstances if—

(A) A remote contingency actually occurs or does not occur, contrary to the assumption made in paragraph (h)(2) of this section;

(B) A payment subject to an incidental contingency described in paragraph (h)(3)(i) of this section becomes fixed in an amount that is not insignificant relative to the total expected amount of the remaining payments on the debt instrument; or

(C) A payment subject to an incidental contingency described in paragraph (h)(3)(ii) of this section becomes fixed such that the difference between the assumed payment date and the due date of the payment is not insignificant.

(ii) *In general*. If a change in circumstances occurs, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the change in circumstances for an amount equal to the instrument's adjusted issue price on that date.

(iii) *Contingent payment debt instruments*. Notwithstanding paragraph

(h)(6)(ii) of this section, in the case of a contingent payment debt instrument subject to §1.1275–4, if a change in circumstances occurs, no retirement or reissuance is treated as occurring, but any payment that is fixed as a result of the change in circumstances is governed by the rules in §1.1275–4 that apply when the amount of a contingent payment becomes fixed.

(7) *Effective date*. This paragraph (h) applies to debt instruments issued on or after August 13, 1996.

(i) [Reserved]

(j) *Treatment of certain modifications*. If the terms of a debt instrument are modified to defer one or more payments, and the modification does not cause an exchange under section 1001, then, solely for purposes of sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date. This paragraph (j) applies to debt instruments issued on or after August 13, 1996.

§1.1275–2T [Removed]

Par. 13. Section 1.1275–2T is removed effective August 13, 1996.

Par. 14. In §1.1275–3, paragraph (b)(1)(i) is revised to read as follows:

§1.1275–3 OID information reporting requirements.

* * * * * *

(b) * * * (1) * * *

(i) Set forth on the face of the debt instrument the issue price, the amount of OID, the issue date, the yield to maturity, and, in the case of a debt instrument subject to the rules of §1.1275–4(b), the comparable yield and projected payment schedule; or

* * * * * *

Par. 15. Section 1.1275–4 is added to read as follows:

§1.1275–4 Contingent payment debt instruments.

(a) *Applicability*—(1) *In general*. Except as provided in paragraph (a)(2) of this section, this section applies to any debt instrument that provides for one or more contingent payments. In general, paragraph (b) of this section applies to a contingent payment debt instrument that is issued for money or publicly traded property and paragraph (c) of this section applies to a contingent payment debt instrument that is issued for nonpublicly traded property. Paragraph (d) of this section provides special rules for tax-exempt obligations. See §1.1275–6 for a taxpayer's treatment of a contingent payment debt instrument and a hedge.

(2) *Exceptions*. This section does not apply to—

(i) A debt instrument that has an issue price determined under section 1273(b)(4) (*e.g.,* a debt instrument subject to section 483);

(ii) A variable rate debt instrument (as defined in §1.1275–5);

(iii) A debt instrument subject to §1.1272–1(c) (a debt instrument that provides for certain contingencies) or §1.1272–1(d) (a debt instrument that provides for a fixed yield);

(iv) A debt instrument subject to section 988 (except as provided in section 988 and the regulations thereunder);

(v) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration);

(vi) A debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2) (*e.g.,* U.S. savings bonds, certain loans between natural persons, and short-term taxable obligations); or

(vii) A debt instrument issued pursuant to a plan or arrangement if—

(A) The plan or arrangement is created by a state statute;

(B) A primary objective of the plan or arrangement is to enable the participants to pay for the costs of post-secondary education for themselves or their designated beneficiaries; and

(C) Contingent payments on the debt instrument are related to such objective.

(3) *Insolvency and default*. A payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances.

(4) *Convertible debt instruments*. A debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer, into the stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.

(5) *Remote and incidental contingencies*. A payment is not a contingent payment merely because of a contingency that, as of the issue date, is either remote or incidental. See §1.1275–2(h) for the treatment of remote and incidental contingencies.

(b) *Noncontingent bond method*—(1) *Applicability*. The noncontingent bond method described in this paragraph (b) applies to a contingent payment debt instrument that has an issue price determined under §1.1273–2 (*e.g.,* a contingent payment debt instrument that is issued for money or publicly traded property).

(2) *In general*. Under the noncontingent bond method, interest on a debt instrument must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of interest that is taken into account for each accrual period is determined by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument. If the actual amount of a contingent payment is not equal to the projected amount, appropriate adjustments are made to reflect the difference.

(3) *Description of method*. The following steps describe how to compute the amount of income, deductions, gain, and loss under the noncontingent bond method:

(i) *Step one: Determine the comparable yield*. Determine the comparable yield for the debt instrument under the rules of paragraph (b)(4) of this section. The comparable yield is determined as of the debt instrument's issue date.

(ii) *Step two: Determine the projected payment schedule*. Determine the projected payment schedule for the debt instrument under the rules of paragraph (b)(4) of this section. The projected payment schedule is determined as of the issue date and remains fixed throughout the term of the debt instrument (except under paragraph (b)(9)(ii) of this section, which applies to a payment that is fixed more than 6 months before it is due).

(iii) *Step three: Determine the daily portions of interest*. Determine the

daily portions of interest on the debt instrument for a taxable year as follows. The amount of interest that accrues in each accrual period is the product of the comparable yield of the debt instrument (properly adjusted for the length of the accrual period) and the debt instrument's adjusted issue price at the beginning of the accrual period. See paragraph (b)(7)(ii) of this section to determine the adjusted issue price of the debt instrument. The daily portions of interest are determined by allocating to each day in the accrual period the ratable portion of the interest that accrues in the accrual period. Except as modified by paragraph (b)(3)(iv) of this section, the daily portions of interest are includible in income by a holder for each day in the holder's taxable year on which the holder held the debt instrument and are deductible by the issuer for each day during the issuer's taxable year on which the issuer was primarily liable on the debt instrument.

(iv) *Step four: Adjust the amount of income or deductions for differences between projected and actual contingent payments*. Make appropriate adjustments to the amount of income or deductions attributable to the debt instrument in a taxable year for any differences between projected and actual contingent payments. See paragraph (b)(6) of this section to determine the amount of an adjustment and the treatment of the adjustment.

(4) *Comparable yield and projected payment schedule*. This paragraph (b)(4) provides rules for determining the comparable yield and projected payment schedule for a debt instrument. The comparable yield and projected payment schedule must be supported by contemporaneous documentation showing that both are reasonable, are based on reliable, complete, and accurate data, and are made in good faith.

(i) *Comparable yield*—(A) *In general*. Except as provided in paragraph (b)(4)(i)(B) of this section, the comparable yield for a debt instrument is the yield at which the issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument (the comparable fixed rate debt instrument), including the level of subordination, term, timing of payments, and general market conditions. For example, if a §1.1275–6 hedge (or the substantial equivalent) is available, the comparable yield is the yield on the synthetic fixed rate debt instrument that would result if the issuer entered into the §1.1275–6 hedge. If a §1.1275–6 hedge (or the substantial equivalent) is not available, but similar fixed rate debt instruments of the issuer trade at a price that reflects a spread above a benchmark rate, the comparable yield is the sum of the value of the benchmark rate on the issue date and the spread. In determining the comparable yield, no adjustments are made for the riskiness of the contingencies or the liquidity of the debt instrument. The comparable yield must be a reasonable yield for the issuer and must not be less than the applicable Federal rate (based on the overall maturity of the debt instrument).

(B) *Presumption for certain debt instruments*. This paragraph (b)(4)(i)(B) applies to a debt instrument if the instrument provides for one or more contingent payments not based on market information and the instrument is part of an issue that is marketed or sold in substantial part to persons for whom the inclusion of interest under this paragraph (b) is not expected to have a substantial effect on their U.S. tax liability. If this paragraph (b)(4)(i)(B) applies to a debt instrument, the instrument's comparable yield is presumed to be the applicable Federal rate (based on the overall maturity of the debt instrument). A taxpayer may overcome this presumption only with clear and convincing evidence that the comparable yield for the debt instrument should be a specific yield (determined using the principles in paragraph (b)(4)(i)(A) of this section) that is higher than the applicable Federal rate. The presumption may not be overcome with appraisals or other valuations of nonpublicly traded property. Evidence used to overcome the presumption must be specific to the issuer and must not be based on comparable issuers or general market conditions.

(ii) *Projected payment schedule*. The projected payment schedule for a debt instrument includes each noncontingent payment and an amount for each contingent payment determined as follows:

(A) *Market-based payments*. If a contingent payment is based on market information (a market-based payment), the amount of the projected payment is the forward price of the contingent payment. The forward price of a contingent payment is the amount one party would agree, as of the issue date, to pay an unrelated party for the right to the contingent payment on the settlement date (*e.g.,* the date the contingent payment is made). For example, if the right to a contingent payment is substantially similar to an exchange-traded option, the forward price is the spot price of the option (the option premium) compounded at the applicable Federal rate from the issue date to the date the contingent payment is due.

(B) *Other payments*. If a contingent payment is not based on market information (a non-market-based payment), the amount of the projected payment is the expected value of the contingent payment as of the issue date.

(C) *Adjustments to the projected payment schedule*. The projected payment schedule must produce the comparable yield. If the projected payment schedule does not produce the comparable yield, the schedule must be adjusted consistent with the principles of this paragraph (b)(4) to produce the comparable yield. For example, the adjusted amounts of non-market-based payments must reasonably reflect the relative expected values of the payments and must not be set to accelerate or defer income or deductions. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for the market-based payments.

(iii) *Market information*. For purposes of this paragraph (b), market information is any information on which an objective rate can be based under §1.1275–5(c)(1) or (2).

(iv) *Issuer/holder consistency*. The issuer's projected payment schedule is used to determine the holder's interest accruals and adjustments. The issuer must provide the projected payment schedule to the holder in a manner consistent with the issuer disclosure rules of §1.1275–2(e). If the issuer does not create a projected payment schedule for a debt instrument or the issuer's projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and projected payment schedule for the debt instrument under the rules of this paragraph (b)(4). A holder that determines its own projected payment schedule must explicitly

disclose this fact and the reason why the holder set its own schedule (*e.g.*, why the issuer's projected payment schedule is unreasonable). Unless otherwise prescribed by the Commissioner, the disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

(v) *Issuer's determination respected*—(A) *In general*. If the issuer maintains the contemporaneous documentation required by this paragraph (b)(4), the issuer's determination of the comparable yield and projected payment schedule will be respected unless either is unreasonable.

(B) *Unreasonable determination*. For purposes of paragraph (b)(4)(v)(A) of this section, a comparable yield or projected payment schedule generally will be considered unreasonable if it is set with a purpose to overstate, understate, accelerate, or defer interest accruals on the debt instrument. In a determination of whether a comparable yield or projected payment schedule is unreasonable, consideration will be given to whether the treatment of the debt instrument under this section is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. For example, if a taxable issuer markets a debt instrument to a holder not subject to U.S. taxation, the comparable yield will be given close scrutiny and will not be respected unless contemporaneous documentation shows that the yield is not too high.

(C) *Exception*. Paragraph (b)(4)(v)(A) of this section does not apply to a debt instrument subject to paragraph (b)(4)(i)(B) of this section (concerning a yield presumption for certain debt instruments that provide for non-market-based payments).

(vi) *Examples*. The following examples illustrate the provisions of this paragraph (b)(4). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Market-based payment—(i) *Facts*. On December 31, 1996, X corporation issues for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest, beginning in 1997, at the rate of 6 percent and for a payment at maturity equal to $1,000,000 plus the excess, if any, of the price of 10,000 shares of publicly traded stock in an unrelated corporation on the maturity date over $350,000, or less the excess, if any, of $350,000 over the price of 10,000 shares of the stock on the maturity date. On the issue date, the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000.

(ii) *Comparable yield*. Under paragraph (b)(4)(i) of this section, the debt instrument's comparable yield is the yield on the synthetic debt instrument that would result if X corporation entered into a §1.1275–6 hedge. A §1.1275–6 hedge in this case is a forward contract to purchase 10,000 shares of the stock on December 31, 2006. If X corporation entered into this hedge, the resulting synthetic debt instrument would yield 6 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6 percent, compounded annually.

(iii) *Projected payment schedule*. Under paragraph (b)(4)(ii) of this section, the projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. Because the right to the contingent payment is based on market information, the projected amount of the contingent payment is the forward price of the payment. The right to the contingent payment is substantially similar to a right to a payment of $1,000,000 combined with a cash-settled forward contract for the purchase of 10,000 shares of the stock for $350,000 on December 31, 2006. Because the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $350,000, the amount to be received or paid under the forward contract is projected to be zero. As a result, the projected amount of the contingent payment at maturity is $1,000,000, consisting of the $1,000,000 base amount and no additional amount to be received or paid under the forward contract.

(A) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $370,000. If X corporation entered into a §1.1275–6 hedge (a forward contract to purchase the shares for $370,000), the resulting synthetic debt instrument would yield 6.15 percent, compounded annually. Thus, the comparable yield on the debt instrument is 6.15 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $1,020,000, consisting of the $1,000,000 base amount plus the excess $20,000 of the forward price of the stock over the purchase price of the stock under the forward contract.

(B) Assume, alternatively, that on the issue date the forward price to purchase 10,000 shares of the stock on December 31, 2006, is $330,000. If X corporation entered into a §1.1275–6 hedge, the resulting synthetic debt instrument would yield 5.85 percent, compounded annually. Thus, the comparable yield on the debt instrument is 5.85 percent, compounded annually. The projected payment schedule for the debt instrument consists of 10 annual payments of $60,000 and a projected amount for the contingent payment at maturity. The projected amount of the contingent payment is $980,000, consisting of the $1,000,000 base amount minus the excess $20,000 of the purchase price of the stock under the forward contract over the forward price of the stock.

Example 2. Non-market-based payments—(i) *Facts*. On December 31, 1996, Y issues to Z for $1,000,000 a debt instrument that matures on December 31, 2000. The debt instrument has a stated principal amount of $1,000,000, payable at maturity, and provides for payments on December 31 of each year, beginning in 1997, of $20,000 plus 1 percent of Y's gross receipts, if any, for the year. On the issue date, Y has outstanding fixed rate debt instruments with maturities of 2 to 10 years that trade at a price that reflects an average of 100 basis points over Treasury bonds. These debt instruments have terms and conditions similar to those of the debt instrument. Assume that on December 31, 1996, 4-year Treasury bonds have a yield of 6.5 percent, compounded annually, and that no §1.1275–6 hedge is available for the debt instrument. In addition, assume that the interest inclusions attributable to the debt instrument are expected to have a substantial effect on Z's U.S. tax liability.

(ii) *Comparable yield*. The comparable yield for the debt instrument is equal to the value of the benchmark rate (*i.e.,* the yield on 4-year Treasury bonds) on the issue date plus the spread. Thus, the debt instrument's comparable yield is 7.5 percent, compounded annually.

(iii) *Projected payment schedule*. Y anticipates that it will have no gross receipts in 1997, but that it will have gross receipts in later years, and those gross receipts will grow each year for the next three years. Based on its business projections, Y believes that it is not unreasonable to expect that its gross receipts in 1999 and each year thereafter will grow by between 6 percent and 13 percent over the prior year. Thus, Y must take these expectations into account in establishing a projected payment schedule for the debt instrument that results in a yield of 7.5 percent, compounded annually. Accordingly, Y could reasonably set the following projected payment schedule for the debt instrument:

Date	*Noncontingent payment*	*Contingent payment*
12/31/1997	$ 20,000	$ 0
12/31/1998	20,000	70,000
12/31/1999	20,000	75,600
12/31/2000	1,020,000	83,850

(5) *Qualified stated interest*. No amounts payable on a debt instrument to which this paragraph (b) applies are qualified stated interest within the meaning of §1.1273–1(c).

(6) *Adjustments*. This paragraph (b)(6) provides rules for the treatment of positive and negative adjustments under the noncontingent bond method. A taxpayer takes into account only those adjustments that occur during a taxable year while the debt instrument is held by the taxpayer or while the taxpayer is primarily liable on the debt instrument.

(i) *Determination of positive and negative adjustments*. If the amount of a contingent payment is more than the projected amount of the contingent payment, the difference is a positive adjustment on the date of the payment.

If the amount of a contingent payment is less than the projected amount of the contingent payment, the difference is a negative adjustment on the date of the payment (or on the scheduled date of the payment if the amount of the payment is zero).

(ii) *Treatment of net positive adjustments*. The amount, if any, by which total positive adjustments on a debt instrument in a taxable year exceed the total negative adjustments on the debt instrument in the taxable year is a net positive adjustment. A net positive adjustment is treated as additional interest for the taxable year.

(iii) *Treatment of net negative adjustments*. The amount, if any, by which total negative adjustments on a debt instrument in a taxable year exceed the total positive adjustments on the debt instrument in the taxable year is a net negative adjustment. A taxpayer's net negative adjustment on a debt instrument for a taxable year is treated as follows:

(A) *Reduction of interest accruals*. A net negative adjustment first reduces interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section.

(B) *Ordinary income or loss*. If the net negative adjustment exceeds the interest for the taxable year that the taxpayer would otherwise account for on the debt instrument under paragraph (b)(3)(iii) of this section, the excess is treated as ordinary loss by a holder and ordinary income by an issuer. However, the amount treated as ordinary loss by a holder is limited to the amount by which the holder's total interest inclusions on the debt instrument exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years. The amount treated as ordinary income by an issuer is limited to the amount by which the issuer's total interest deductions on the debt instrument exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years.

(C) *Carryforward*. If the net negative adjustment exceeds the sum of the amounts treated by the taxpayer as a reduction of interest and as ordinary income or loss (as the case may be) on the debt instrument for the taxable year, the excess is a negative adjustment carryforward for the taxable year. In general, a taxpayer treats a negative adjustment carryforward for a taxable year as a negative adjustment on the debt instrument on the first day of the succeeding taxable year. However, if a holder of a debt instrument has a negative adjustment carryforward on the debt instrument in a taxable year in which the debt instrument is sold, exchanged, or retired, the negative adjustment carryforward reduces the holder's amount realized on the sale, exchange, or retirement. If an issuer of a debt instrument has a negative adjustment carryforward on the debt instrument for a taxable year in which the debt instrument is retired, the issuer takes the negative adjustment carryforward into account as ordinary income.

(D) *Treatment under section 67*. A net negative adjustment is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions).

(iv) *Cross-references*. If a holder has a basis in a debt instrument that is different from the debt instrument's adjusted issue price, the holder may have additional positive or negative adjustments under paragraph (b)(9)(i) of this section. If the amount of a contingent payment is fixed more than 6 months before the date it is due, the amount and timing of the adjustment are determined under paragraph (b)(9)(ii) of this section.

(7) *Adjusted issue price, adjusted basis, and retirement*—(i) *In general*. If a debt instrument is subject to the noncontingent bond method, this paragraph (b)(7) provides rules to determine the adjusted issue price of the debt instrument, the holder's basis in the debt instrument, and the treatment of any scheduled or unscheduled retirements. In general, because any difference between the actual amount of a contingent payment and the projected amount of the payment is taken into account as an adjustment to income or deduction, the projected payments are treated as the actual payments for purposes of making adjustments to issue price and basis and determining the amount of any contingent payment made on a scheduled retirement.

(ii) *Definition of adjusted issue price*. The adjusted issue price of a debt instrument is equal to the debt instrument's issue price, increased by the interest previously accrued on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument. See paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iii) *Adjustments to basis*. A holder's basis in a debt instrument is increased by the interest previously accrued by the holder on the debt instrument under paragraph (b)(3)(iii) of this section (determined without regard to any adjustments taken into account under paragraph (b)(3)(iv) of this section), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. See paragraph (b)(9)(i) of this section for special rules that apply when basis is different from adjusted issue price and paragraph (b)(9)(ii) of this section for special rules that apply when a contingent payment is fixed more than 6 months before it is due.

(iv) *Scheduled retirements*. For purposes of determining the amount realized by a holder and the repurchase price paid by the issuer on the scheduled retirement of a debt instrument, a holder is treated as receiving, and the issuer is treated as paying, the projected amount of any contingent payment due at maturity. If the amount paid or received is different from the projected amount, see paragraph (b)(6) of this section for the treatment of the difference by the taxpayer. Under paragraph (b)(6)(iii)(C) of this section, the amount realized by a holder on the retirement of a debt instrument is reduced by any negative adjustment carryforward determined in the taxable year of the retirement.

(v) *Unscheduled retirements*. An unscheduled retirement of a debt instrument (or the receipt of a pro-rata prepayment that is treated as a retirement of a portion of a debt instrument under §1.1275-2(f)) is treated as a repurchase of the debt instrument (or a pro-rata portion of the debt instrument) by the issuer from the holder for the amount paid by the issuer to the holder.

(vi) *Examples*. The following examples illustrate the provisions of paragraphs (b)(6) and (7) of this section. In

each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Treatment of positive and negative adjustments—(i) *Facts*. On December 31, 1996, Z, a calendar year taxpayer, purchases a debt instrument subject to this paragraph (b) at original issue for $1,000. The debt instrument's comparable yield is 10 percent, compounded annually, and the projected payment schedule provides for payments of $500 on December 31, 1997 (consisting of a noncontingent payment of $375 and a projected amount of $125) and $660 on December 31, 1998 (consisting of a noncontingent payment of $600 and a projected amount of $60). The debt instrument is a capital asset in the hands of Z.

(ii) *Adjustment in 1997*. Based on the projected payment schedule, Z's total daily portions of interest on the debt instrument are $100 for 1997 (issue price of $1,000 x 10 percent). Assume that the payment actually made on December 31, 1997, is $375, rather than the projected $500. Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $125 on December 31, 1997, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z has no positive adjustments for 1997, Z has a net negative adjustment of $125 on the debt instrument for 1997. This net negative adjustment reduces to zero the $100 total daily portions of interest Z would otherwise include in income in 1997. Accordingly, Z has no interest income on the debt instrument for 1997. Because Z had no interest inclusions on the debt instrument for prior taxable years, the remaining $25 of the net negative adjustment is a negative adjustment carryforward for 1997 that results in a negative adjustment of $25 on January 1, 1998.

(iii) *Adjustment to issue price and basis*. Z's total daily portions of interest on the debt instrument are $100 for 1997. The adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are increased by this amount, despite the fact that Z does not include this amount in income because of the net negative adjustment for 1997. In addition, the adjusted issue price of the debt instrument and Z's adjusted basis in the debt instrument are decreased on December 31, 1997, by the projected amount of the payment on that date ($500). Thus, on January 1, 1998, Z's adjusted basis in the debt instrument and the adjusted issue price of the debt instrument are $600.

(iv) *Adjustments in 1998*. Based on the projected payment schedule, Z's total daily portions of interest are $60 for 1998 (adjusted issue price of $600 × 10 percent). Assume that the payment actually made on December 31, 1998, is $700, rather than the projected $660. Under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $40 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Because Z also has a negative adjustment of $25 on January 1, 1998, Z has a net positive adjustment of $15 on the debt instrument for 1998 (the excess of the $40 positive adjustment over the $25 negative adjustment). As a result, Z has $75 of interest income on the debt instrument for 1998 (the $15 net positive adjustment plus the $60 total daily portions of interest that are taken into account by Z in that year).

(v) *Retirement*. Based on the projected payment schedule, Z's adjusted basis in the debt instrument immediately before the payment at maturity is $660 ($600 plus $60 total daily portions of interest for 1998). Even though Z receives $700 at maturity, for purposes of determining the amount realized by Z on retirement of the debt instrument, Z is treated as receiving the projected amount of the contingent payment on December 31, 1998. Therefore, Z is treated as receiving $660 on December 31, 1998. Because Z's adjusted basis in the debt instrument immediately before its retirement is $660, Z recognizes no gain or loss on the retirement.

Example 2. Negative adjustment carryforward for year of sale—(i) *Facts*. Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that Z sells the debt instrument on January 1, 1998, for $630.

(ii) *Gain on sale*. On the date the debt instrument is sold, Z's adjusted basis in the debt instrument is $600. Because Z has a negative adjustment of $25 on the debt instrument on January 1, 1998, and has no positive adjustments on the debt instrument in 1998, Z has a net negative adjustment for 1998 of $25. Because Z has not included in income any interest on the debt instrument, the entire $25 net negative adjustment is a negative adjustment carryforward for the taxable year of the sale. Under paragraph (b)(6)(iii)(C) of this section, the $25 negative adjustment carryforward reduces the amount realized by Z on the sale of the debt instrument from $630 to $605. Thus, Z has a gain on the sale of $5 ($605 – $600). Under paragraph (b)(8)(i) of this section, the gain is treated as interest income.

Example 3. Negative adjustment carryforward for year of retirement—(i) *Facts*. Assume the same facts as in *Example 1* of this paragraph (b)(7)(vi), except that the payment actually made on December 31, 1998, is $615, rather than the projected $660.

(ii) *Adjustments in 1998*. Under paragraph (b)(6)(i) of this section, Z has a negative adjustment of $45 on December 31, 1998, attributable to the difference between the amount of the actual payment and the amount of the projected payment. In addition, Z has a negative adjustment of $25 on January 1, 1998. See *Example 1* (ii) of this paragraph (b)(7)(vi). Because Z has no positive adjustments in 1998, Z has a net negative adjustment of $70 for 1998. This net negative adjustment reduces to zero the $60 total daily portions of interest Z would otherwise include in income for 1998. Therefore, Z has no interest income on the debt instrument for 1998. Because Z had no interest inclusions on the debt instrument for 1997, the remaining $10 of the net negative adjustment is a negative adjustment carryforward for 1998 that reduces the amount realized by Z on retirement of the debt instrument.

(iii) *Loss on retirement*. Immediately before the payment at maturity, Z's adjusted basis in the debt instrument is $660. Under paragraph (b)(7)(iv) of this section, Z is treated as receiving the projected amount of the contingent payment, or $660, as the payment at maturity. Under paragraph (b)(6)(iii)(C) of this section, however, this amount is reduced by any negative adjustment carryforward determined for the taxable year of retirement to calculate the amount Z realizes on retirement of the debt instrument. Thus, Z has a loss of $10 on the retirement of the debt instrument, equal to the amount by which Z's adjusted basis in the debt instrument ($660) exceeds the amount Z realizes on the retirement of the debt instrument ($660 minus the $10 negative adjustment carryforward). Under paragraph (b)(8)(ii) of this section, the loss is a capital loss.

(8) *Character on sale, exchange, or retirement*—(i) *Gain*. Any gain recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is interest income.

(ii) *Loss*. Any loss recognized by a holder on the sale, exchange, or retirement of a debt instrument subject to this paragraph (b) is ordinary loss to the extent that the holder's total interest inclusions on the debt instrument exceed the total net negative adjustments on the debt instrument the holder took into account as ordinary loss. Any additional loss is treated as loss from the sale, exchange, or retirement of the debt instrument. However, any loss that would otherwise be ordinary under this paragraph (b)(8)(ii) and that is attributable to the holder's basis that could not be amortized under section 171(b)(4) is loss from the sale, exchange, or retirement of the debt instrument.

(iii) *Special rule if there are no remaining contingent payments on the debt instrument*—(A) *In general*. Notwithstanding paragraphs (b)(8)(i) and (ii) of this section, if, at the time of the sale, exchange, or retirement of the debt instrument, there are no remaining contingent payments due on the debt instrument under the projected payment schedule, any gain or loss recognized by the holder is gain or loss from the sale, exchange, or retirement of the debt instrument. See paragraph (b)(9)(ii) of this section to determine whether there are no remaining contingent payments on a debt instrument that provides for fixed but deferred contingent payments.

(B) *Exception for certain positive adjustments*. Notwithstanding paragraph (b)(8)(iii)(A) of this section, if a positive adjustment on a debt instrument is spread under paragraph (b)(9)(ii)(F) or (G) of this section, any gain recognized by the holder on the sale, exchange, or retirement of the instrument is treated as interest income to the extent of the positive adjustment that has not yet been accrued and included in income by the holder.

(iv) *Examples*. The following examples illustrate the provisions of this paragraph (b)(8). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Gain on sale—(i) *Facts*. On January 1, 1998, D, a calendar year taxpayer, sells a debt instrument that is subject to paragraph (b) of this section for $1,350. The projected payment schedule for the debt instrument provides for contingent payments after January 1, 1998. On January 1, 1998, D has an adjusted basis in the debt instrument of $1,200. In addition, D has a negative adjustment carryforward of $50 for 1997 that, under paragraph (b)(6)(iii)(C) of this section, results in a negative adjustment of $50 on January 1, 1998. D has no positive adjustments on the debt instrument on January 1, 1998.

(ii) *Character of gain*. Under paragraph (b)(6) of this section, the $50 negative adjustment on January 1, 1998, results in a negative adjustment carryforward for 1998, the taxable year of the sale of the debt instrument. Under paragraph (b)(6)(iii)(C) of this section, the negative adjustment carryforward reduces the amount realized by D on the sale of the debt instrument from $1,350 to $1,300. As a result, D realizes a $100 gain on the sale of the debt instrument, equal to the $1,300 amount realized minus D's $1,200 adjusted basis in the debt instrument. Under paragraph (b)(8)(i) of this section, the gain is interest income to D.

Example 2. Loss on sale—(i) *Facts*. On December 31, 1996, E, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument is a capital asset in the hands of E. The debt instrument provides for a single payment on December 31, 1998 (the maturity date of the instrument), of $1,000 plus an amount based on the increase, if any, in the price of a specified commodity over the term of the instrument. The comparable yield for the debt instrument is 9.54 percent, compounded annually, and the projected payment schedule provides for a payment of $1,200 on December 31, 1998. Based on the projected payment schedule, the total daily portions of interest are $95 for 1997 and $105 for 1998.

(ii) *Ordinary loss*. Assume that E sells the debt instrument for $1,050 on December 31, 1997. On that date, E has an adjusted basis in the debt instrument of $1,095 ($1,000 original basis, plus total daily portions of $95 for 1997). Therefore, E realizes a $45 loss on the sale of the debt instrument ($1,050 – $1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, the $45 loss is an ordinary loss.

(iii) *Capital loss*. Alternatively, assume that E sells the debt instrument for $990 on December 31, 1997. E realizes a $105 loss on the sale of the debt instrument ($990 – $1,095). The loss is ordinary to the extent E's total interest inclusions on the debt instrument ($95) exceed the total net negative adjustments on the instrument that E took into account as an ordinary loss. Because E has not had any net negative adjustments on the debt instrument, $95 of the $105 loss is an ordinary loss. The remaining $10 of the $105 loss is a capital loss.

(9) *Operating rules*. The rules of this paragraph (b)(9) apply to a debt instrument subject to the noncontingent bond method notwithstanding any other rule of this paragraph (b).

(i) *Basis different from adjusted issue price*. This paragraph (b)(9)(i) provides rules for a holder whose basis in a debt instrument is different from the adjusted issue price of the debt instrument (*e.g.,* a subsequent holder that purchases the debt instrument for more or less than the instrument's adjusted issue price).

(A) *General rule*. The holder accrues interest under paragraph (b)(3)(iii) of this section and makes adjustments under paragraph (b)(3)(iv) of this section based on the projected payment schedule determined as of the issue date of the debt instrument. However, upon acquiring the debt instrument, the holder must reasonably allocate any difference between the adjusted issue price and the basis to daily portions of interest or projected payments over the remaining term of the debt instrument. Allocations are taken into account under paragraphs (b)(9)(i)(B) and (C) of this section.

(B) *Basis greater than adjusted issue price*. If the holder's basis in the debt instrument exceeds the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a negative adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is reduced by the amount the holder treats as a negative adjustment under this paragraph (b)(9)(i)(B). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(C) *Basis less than adjusted issue price*. If the holder's basis in the debt instrument is less than the debt instrument's adjusted issue price, the amount of the difference allocated to a daily portion of interest or to a projected payment is treated as a positive adjustment on the date the daily portion accrues or the payment is made. On the date of the adjustment, the holder's adjusted basis in the debt instrument is increased by the amount the holder treats as a positive adjustment under this paragraph (b)(9)(i)(C). See paragraph (b)(9)(ii)(E) of this section for a special rule that applies when a contingent payment is fixed more than 6 months before it is due.

(D) *Premium and discount rules do not apply*. The rules for accruing premium and discount in sections 171, 1272(a)(7), 1276, and 1281 do not apply. Other rules of those sections, such as section 171(b)(4), continue to apply to the extent relevant.

(E) *Safe harbor for exchange listed debt instruments*. If the debt instrument is exchange listed property (within the meaning of §1.1273–2(f)(2)), it is reasonable for the holder to allocate any difference between the holder's basis and the adjusted issue price of the debt instrument pro-rata to daily portions of interest (as determined under paragraph (b)(3)(iii) of this section) over the remaining term of the debt instrument. A pro-rata allocation is not reasonable, however, to the extent the holder's yield on the debt instrument, determined after taking into account the amounts allocated under this paragraph (b)(9)(i)(E), is less than the applicable Federal rate for the instrument. For purposes of the preceding sentence, the applicable Federal rate for the debt instrument is determined as if the purchase date were the issue date and the remaining term of the instrument were the term of the instrument.

(F) *Examples*. The following examples illustrate the provisions of this paragraph (b)(9)(i). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. In addition, assume that each instrument is not exchange listed property.

Example 1. Basis greater than adjusted issue price—(i) *Facts*. On July 1, 1998, Z purchases for $1,405 a debt instrument that matures on December 31, 1999, and promises to pay on the maturity date $1,000 plus the increase, if any, in the price of a specified amount of a commodity from the issue date to the maturity date. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for a single payment at maturity of $1,350. At the time of the purchase, the debt instrument has

an adjusted issue price of $1,162, assuming semiannual accrual periods ending on December 31 and June 30 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment and not to a decrease in market interest rates. The debt instrument is a capital asset in the hands of Z. Z is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price*. Z's basis in the debt instrument on July 1, 1998, is $1,405. Under paragraph (b)(9)(i)(A) of this section, Z allocates the $243 difference between basis ($1,405) and adjusted issue price ($1,162) to the contingent payment at maturity. Z's allocation of the difference between basis and adjusted issue price is reasonable because the increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment.

(iii) *Treatment of debt instrument for 1998*. Based on the projected payment schedule, $60 of interest accrues on the debt instrument from July 1, 1998 to December 31, 1998 (the product of the debt instrument's adjusted issue price on July 1, 1998 ($1,162) and the comparable yield properly adjusted for the length of the accrual period (10.25 percent/2)). Z has no net negative or positive adjustments for 1998. Thus, Z includes in income $60 of total daily portions of interest for 1998. On December 31, 1998, Z's adjusted basis in the debt instrument is $1,465 ($1,405 original basis, plus total daily portions of $60 for 1998).

(iv) *Effect of allocation to contingent payment at maturity*. Assume that the payment actually made on December 31, 1999, is $1,400, rather than the projected $1,350. Thus, under paragraph (b)(6)(i) of this section, Z has a positive adjustment of $50 on December 31, 1999. In addition, under paragraph (b)(9)(i)(B) of this section, Z has a negative adjustment of $243 on December 31, 1999, which is attributable to the difference between Z's basis in the debt instrument on July 1, 1998, and the instrument's adjusted issue price on that date. As a result, Z has a net negative adjustment of $193 for 1999. This net negative adjustment reduces to zero the $128 total daily portions of interest Z would otherwise include in income in 1999. Accordingly, Z has no interest income on the debt instrument for 1999. Because Z had $60 of interest inclusions for 1998, $60 of the remaining $65 net negative adjustment is treated by Z as an ordinary loss for 1999. The remaining $5 of the net negative adjustment is a negative adjustment carryforward for 1999 that reduces the amount realized by Z on the retirement of the debt instrument from $1,350 to $1,345.

(v) *Loss at maturity*. On December 31, 1999, Z's basis in the debt instrument is $1,350 ($1,405 original basis, plus total daily portions of $60 for 1998 and $128 for 1999, minus the negative adjustment of $243). As a result, Z realizes a loss of $5 on the retirement of the debt instrument (the difference between the amount realized on the retirement ($1,345) and Z's adjusted basis in the debt instrument ($1,350)). Under paragraph (b)(8)(ii) of this section, the $5 loss is treated as loss from the retirement of the debt instrument. Consequently, Z realizes a total loss of $65 on the debt instrument for 1999 (a $60 ordinary loss and a $5 capital loss).

Example 2. Basis less than adjusted issue price—(i) *Facts*. On January 1, 1999, Y purchases for $910 a debt instrument that pays 7 percent interest semiannually on June 30 and December 31 of each year, and that promises to pay on December 31, 2001, $1,000 plus or minus $10 times the positive or negative difference, if any, between a specified amount and the value of an index on December 31, 2001. However, the payment on December 31, 2001, may not be less than $650. The debt instrument was originally issued on December 31, 1996, for an issue price of $1,000. The comparable yield for the debt instrument is 9.80 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date) provides for semiannual payments of $35 and a contingent payment at maturity of $1,175. On January 1, 1999, the debt instrument has an adjusted issue price of $1,060, assuming semiannual accrual periods ending on December 31 and June 30 of each year. Y is a calendar year taxpayer.

(ii) *Allocation of the difference between basis and adjusted issue price*. Y's basis in the debt instrument on January 1, 1999, is $910. Under paragraph (b)(9)(i)(A) of this section, Y must allocate the $150 difference between basis ($910) and adjusted issue price ($1,060) to daily portions of interest or to projected payments. These amounts will be positive adjustments taken into account at the time the daily portions accrue or the payments are made.

(A) Assume that, because of a decrease in the relevant index, the expected value of the payment at maturity has declined by about 9 percent. Based on forward prices on January 1, 1999, Y determines that approximately $105 of the difference between basis and adjusted issue price is allocable to the contingent payment. Y allocates the remaining $45 to daily portions of interest on a pro-rata basis (i.e., the amount allocated to an accrual period equals the product of $45 and a fraction, the numerator of which is the total daily portions for the accrual period and the denominator of which is the total daily portions remaining on the debt instrument on January 1, 1999). This allocation is reasonable.

(B) Assume alternatively that, based on yields of comparable debt instruments and its purchase price for the debt instrument, Y determines that an appropriate yield for the debt instrument is 13 percent, compounded semiannually. Based on this determination, Y allocates $55.75 of the difference between basis and adjusted issue price to daily portions of interest as follows: $15.19 to the daily portions of interest for the taxable year ending December 31, 1999; $18.40 to the daily portions of interest for the taxable year ending December 31, 2000; and $22.16 to the daily portions of interest for the taxable year ending December 31, 2001. Y allocates the remaining $94.25 to the contingent payment at maturity. This allocation is reasonable.

(ii) *Fixed but deferred contingent payments*. This paragraph (b)(9)(ii) provides rules that apply when the amount of a contingent payment becomes fixed before the payment is due. For purposes of paragraph (b) of this section, if a contingent payment becomes fixed within the 6-month period ending on the due date of the payment, the payment is treated as a contingent payment even after the payment is fixed. If a contingent payment becomes fixed more than 6 months before the payment is due, the following rules apply to the debt instrument.

(A) *Determining adjustments*. The amount of the adjustment attributable to the contingent payment is equal to the difference between the present value of the amount that is fixed and the present value of the projected amount of the contingent payment. The present value of each amount is determined by discounting the amount from the date the payment is due to the date the payment becomes fixed, using a discount rate equal to the comparable yield on the debt instrument. The adjustment is treated as a positive or negative adjustment, as appropriate, on the date the contingent payment becomes fixed. See paragraph (b)(9)(ii)(G) of this section to determine the timing of the adjustment if all remaining contingent payments on the debt instrument become fixed substantially contemporaneously.

(B) *Payment schedule*. The contingent payment is no longer treated as a contingent payment after the date the amount of the payment becomes fixed. On the date the contingent payment becomes fixed, the projected payment schedule for the debt instrument is modified prospectively to reflect the fixed amount of the payment. Therefore, no adjustment is made under paragraph (b)(3)(iv) of this section when the contingent payment is actually made.

(C) *Accrual period*. Notwithstanding the determination under §1.1272–1(b)(1)(ii) of accrual periods for the debt instrument, an accrual period ends on the day the contingent payment becomes fixed, and a new accrual period begins on the day after the day the contingent payment becomes fixed.

(D) *Adjustments to basis and adjusted issue price*. The amount of any positive adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section increases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument. Similarly, the amount of any negative adjustment on a debt instrument determined under paragraph (b)(9)(ii)(A) of this section decreases the adjusted issue price of the instrument and the holder's adjusted basis in the instrument.

(E) *Basis different from adjusted issue price*. If a holder's basis in a debt instrument exceeds the debt instrument's adjusted issue price, the amount

allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a negative adjustment on the date the payment becomes fixed. If a holder's basis in a debt instrument is less than the debt instrument's adjusted issue price, the amount allocated to a projected payment under paragraph (b)(9)(i) of this section is treated as a positive adjustment on the date the payment becomes fixed.

(F) *Special rule for certain contingent interest payments*. Notwithstanding paragraph (b)(9)(ii)(A) of this section, this paragraph (b)(9)(ii)(F) applies to contingent stated interest payments that are adjusted to compensate for contingencies regarding the reasonableness of the debt instrument's stated rate of interest. For example, this paragraph (b)(9)(ii)(F) applies to a debt instrument that provides for an increase in the stated rate of interest if the credit quality of the issuer or liquidity of the debt instrument deteriorates. Contingent stated interest payments of this type are recognized over the period to which they relate in a reasonable manner.

(G) *Special rule when all contingent payments become fixed*. Notwithstanding paragraph (b)(9)(ii)(A) of this section, if all the remaining contingent payments on a debt instrument become fixed substantially contemporaneously, any positive or negative adjustments on the instrument are taken into account in a reasonable manner over the period to which they relate. For purposes of the preceding sentence, a payment is treated as a fixed payment if all remaining contingencies with respect to the payment are remote or incidental (within the meaning of §1.1275–2(h)).

(H) *Example*. The following example illustrates the provisions of this paragraph (b)(9)(ii). In this example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example. *Fixed but deferred payments*—(i) *Facts*. On December 31, 1996, B, a calendar year taxpayer, purchases a debt instrument at original issue for $1,000. The debt instrument matures on December 31, 2002, and provides for a payment of $1,000 at maturity. In addition, on December 31, 1999, and December 31, 2002, the debt instrument provides for payments equal to the excess of the average daily value of an index for the 6-month period ending on September 30 of the preceding year over a specified amount. The debt instrument's comparable yield is 10 percent, compounded annually, and the instrument's projected payment schedule consists of a payment of $250 on December 31, 1999, and a payment of $1,439 on December 31, 2002. B uses annual accrual periods.

(ii) *Interest accrual for 1997*. Based on the projected payment schedule, B includes a total of $100 of daily portions of interest in income in 1997. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1997, is $1,100.

(iii) *Interest accrual for 1998*—(A) *Adjustment*. Based on the projected payment schedule, B would include $110 of total daily portions of interest in income in 1998. However, assume that on September 30, 1998, the payment due on December 31, 1999, fixes at $300, rather than the projected $250. Thus, on September 30, 1998, B has an adjustment equal to the difference between the present value of the $300 fixed amount and the present value of the $250 projected amount of the contingent payment. The present values of the two payments are determined by discounting each payment from the date the payment is due (December 31, 1999) to the date the payment becomes fixed (September 30, 1998), using a discount rate equal to 10 percent, compounded annually. The present value of the fixed payment is $266.30 and the present value of the projected amount of the contingent payment is $221.91. Thus, on September 30, 1998, B has a positive adjustment of $44.39 ($266.30 − $221.91).

(B) *Effect of adjustment*. Under paragraph (b)(9)(ii)(C) of this section, B's accrual period ends on September 30, 1998. The daily portions of interest on the debt instrument for the period from January 1, 1998 to September 30, 1998 total $81.51. The adjusted issue price of the debt instrument and B's adjusted basis in the debt instrument are thus increased over this period by $125.90 (the sum of the daily portions of interest of $81.51 and the positive adjustment of $44.39 made at the end of the period) to $1,225.90. For purposes of all future accrual periods, including the new accrual period from October 1, 1998, to December 31, 1998, the debt instrument's projected payment schedule is modified to reflect a fixed payment of $300 on December 31, 1999. Based on the new adjusted issue price of the debt instrument and the new projected payment schedule, the yield on the debt instrument does not change.

(C) *Interest accrual for 1998*. Based on the modified projected payment schedule, $29.56 of interest accrues during the accrual period that ends on December 31, 1998. Because B has no other adjustments during 1998, the $44.39 positive adjustment on September 30, 1998, results in a net positive adjustment for 1998, which is additional interest for that year. Thus, B includes $155.46 ($81.51 + $29.56 + $44.39) of interest in income in 1998. B's adjusted basis in the debt instrument and the debt instrument's adjusted issue price on December 31, 1998, is $1,255.46 ($1,225.90 from the end of the prior accrual period plus $29.56 total daily portions for the current accrual period).

(iii) *Timing contingencies*. This paragraph (b)(9)(iii) provides rules for debt instruments that have payments that are contingent as to time.

(A) *Treatment of certain options*. If a taxpayer has an unconditional option to put or call the debt instrument, to exchange the debt instrument for other property, or to extend the maturity date of the debt instrument, the projected payment schedule is determined by using the principles of §1.1272–1(c)(5).

(B) *Other timing contingencies*. [Reserved]

(iv) *Cross-border transactions*—(A) *Allocation of deductions*. For purposes of §1.861–8, the holder of a debt instrument shall treat any deduction or loss treated as an ordinary loss under paragraph (b)(6)(iii)(B) or (b)(8)(ii) of this section as a deduction that is definitely related to the class of gross income to which income from such debt instrument belongs. Accordingly, if a U.S. person holds a debt instrument issued by a related controlled foreign corporation and, pursuant to section 904(d)(3) and the regulations thereunder, any interest accrued by such U.S. person with respect to such debt instrument would be treated as foreign source general limitation income, any deductions relating to a net negative adjustment will reduce the U.S. person's foreign source general limitation income. The holder shall apply the general rules relating to allocation and apportionment of deductions to any other deduction or loss realized by the holder with respect to the debt instrument.

(B) *Investments in United States real property*. Notwithstanding paragraph (b)(8)(i) of this section, gain on the sale, exchange, or retirement of a debt instrument that is a United States real property interest is treated as gain for purposes of sections 897, 1445, and 6039C.

(v) *Coordination with subchapter M and related provisions*. For purposes of sections 852(c)(2) and 4982 and §1.852–11, any positive adjustment, negative adjustment, income, or loss on a debt instrument that occurs after October 31 of a taxable year is treated in the same manner as foreign currency gain or loss that is attributable to a section 988 transaction.

(vi) *Coordination with section 1092*. A holder treats a negative adjustment and an issuer treats a positive adjustment as a loss with respect to a position in a straddle if the debt instrument is a position in a straddle and the contingency (or any portion of the contingency) to which the adjustment relates would be part of the straddle if entered into as a separate position.

(c) *Method for debt instruments not subject to the noncontingent bond method*—(1) *Applicability*. This paragraph (c) applies to a contingent payment debt instrument (other than a tax-exempt obligation) that has an issue price determined under §1.1274–2. For example, this paragraph (c) generally applies to a contingent payment debt instrument that is issued for non-publicly traded property.

(2) *Separation into components*. If paragraph (c) of this section applies to a debt instrument (the overall debt instrument), the noncontingent payments are subject to the rules in paragraph (c)(3) of this section, and the contingent payments are accounted for separately under the rules in paragraph (c)(4) of this section.

(3) *Treatment of noncontingent payments*. The noncontingent payments are treated as a separate debt instrument. The issue price of the separate debt instrument is the issue price of the overall debt instrument, determined under §1.1274–2(g). No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273–1(c)) and the de minimis rules of section 1273(a)(3) and §1.1273–1(d) do not apply to the separate debt instrument.

(4) *Treatment of contingent payments*—(i) *In general*. Except as provided in paragraph (c)(4)(iii) of this section, the portion of a contingent payment treated as interest under paragraph (c)(4)(ii) of this section is includible in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the payment is made.

(ii) *Characterization of contingent payments as principal and interest*—(A) *General rule*. A contingent payment is treated as a payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate from the date the payment is made to the issue date. The amount of the payment in excess of the amount treated as principal under the preceding sentence is treated as a payment of interest.

(B) *Test rate*. The test rate used for purposes of paragraph (c)(4)(ii)(A) of this section is the rate that would be the test rate for the overall debt instrument under §1.1274–4 if the term of the overall debt instrument began on the issue date of the overall debt instrument and ended on the date the contingent payment is made. However, in the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds the test rate determined under the preceding sentence, the test rate is the stated interest rate.

(iii) *Certain delayed contingent payments*—(A) *General rule*. Notwithstanding paragraph (c)(4)(ii) of this section, if a contingent payment becomes fixed more than 6 months before the payment is due, the issuer and holder are treated as if the issuer had issued a separate debt instrument on the date the payment becomes fixed, maturing on the date the payment is due. This separate debt instrument is treated as a debt instrument to which section 1274 applies. The stated principal amount of this separate debt instrument is the amount of the payment that becomes fixed. An amount equal to the issue price of this debt instrument is characterized as interest or principal under the rules of paragraph (c)(4)(ii) of this section and accounted for as if this amount had been paid by the issuer to the holder on the date that the amount of the payment becomes fixed. To determine the issue price of the separate debt instrument, the payment is discounted at the test rate from the maturity date of the separate debt instrument to the date that the amount of the payment becomes fixed.

(B) *Test rate*. The test rate used for purposes of paragraph (c)(4)(iii)(A) of this section is determined in the same manner as the test rate under paragraph (c)(4)(ii)(B) of this section is determined except that the date the contingent payment is due is used rather than the date the contingent payment is made.

(5) *Basis different from adjusted issue price*. This paragraph (c)(5) provides rules for a holder whose basis in a debt instrument is different from the instrument's adjusted issue price (*e.g.*, a subsequent holder). This paragraph (c)(5), however, does not apply if the holder is reporting income under the installment method of section 453.

(i) *Allocation of basis*. The holder must allocate basis to the noncontingent component (*i.e.*, the right to the noncontingent payments) and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining basis, if any, to the contingent component (*i.e.*, the right to the contingent payments).

(ii) *Noncontingent component*. Any difference between the holder's basis in the noncontingent component and the adjusted issue price of the noncontingent component, and any difference between the holder's basis in a separate debt instrument and the adjusted issue price of the separate debt instrument, is taken into account under the rules for market discount, premium, and acquisition premium that apply to a noncontingent debt instrument.

(iii) *Contingent component*. Amounts received by the holder that are treated as principal payments under paragraph (c)(4)(ii) of this section reduce the holder's basis in the contingent component. If the holder's basis in the contingent component is reduced to zero, any additional principal payments on the contingent component are treated as gain from the sale or exchange of the debt instrument. Any basis remaining on the contingent component on the date the final contingent payment is made increases the holder's adjusted basis in the noncontingent component (or, if there are no remaining noncontingent payments, is treated as loss from the sale or exchange of the debt instrument).

(6) *Treatment of a holder on sale, exchange, or retirement*. This paragraph (c)(6) provides rules for the treatment of a holder on the sale, exchange, or retirement of a debt instrument subject to paragraph (c) of this section. Under this paragraph (c)(6), the holder must allocate the amount received from the sale, exchange, or retirement of a debt instrument first to the noncontingent component and to any separate debt instruments described in paragraph (c)(4)(iii) of this section in an amount up to the total of the adjusted issue price of the noncontingent component and the adjusted issue prices of the separate debt instruments. The holder must allocate the remaining amount received, if any, to the contingent component.

(i) *Amount allocated to the noncontingent component*. The amount allo-

cated to the noncontingent component and any separate debt instruments is treated as an amount realized from the sale, exchange, or retirement of the noncontingent component or separate debt instrument.

(ii) *Amount allocated to the contingent component*. The amount allocated to the contingent component is treated as a contingent payment that is made on the date of the sale, exchange, or retirement and is characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section.

(7) *Examples*. The following examples illustrate the provisions of this paragraph (c). In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1. Contingent interest payments—(i) *Facts*. A owns Blackacre, unencumbered depreciable real estate. On January 1, 1997, A sells Blackacre to B. As consideration for the sale, B makes a downpayment of $1,000,000 and issues to A a debt instrument that matures on December 31, 2001. The debt instrument provides for a payment of principal at maturity of $5,000,000 and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents B receives from Blackacre in that year. Assume that the debt instrument is not issued in a potentially abusive situation. Assume also that on January 1, 1997, the short-term applicable Federal rate is 5 percent, compounded annually, and the mid-term applicable Federal rate is 6 percent, compounded annually.

(ii) *Determination of issue price*. Under §1.1274–2(g), the issue price of the debt instrument is $3,736,291, which is the present value, as of the issue date, of the $5,000,000 noncontingent payment due at maturity, calculated using a discount rate equal to the mid-term applicable Federal rate. Under §1.1012–1(g)(1), B's basis in Blackacre on January 1, 1997, is $4,736,291 ($1,000,000 down payment plus the $3,736,291 issue price of the debt instrument).

(iii) *Noncontingent payment treated as separate debt instrument*. Under paragraph (c)(3) of this section, the right to the noncontingent payment of principal at maturity is treated as a separate debt instrument. The issue price of this separate debt instrument is $3,736,291 (the issue price of the overall debt instrument). The separate debt instrument has a stated redemption price at maturity of $5,000,000 and, therefore, OID of $1,263,709.

(iv) *Treatment of contingent payments*. Assume that the amount of contingent interest that is fixed and paid on December 31, 1997, is $200,000. Under paragraph (c)(4)(ii) of this section, this payment is treated as consisting of a payment of principal of $190,476, which is the present value of the payment, determined by discounting the payment at the test rate of 5 percent, compounded annually, from the date the payment is made to the issue date. The remainder of the $200,000 payment ($9,524) is treated as interest. The additional amount treated as principal gives B additional basis in Blackacre on December 31, 1997. The portion of the payment treated as interest is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs. The remaining contingent payments on the debt instrument are accounted for similarly, using a test rate of 5 percent, compounded annually, for the contingent payments due on December 31, 1998, and December 31, 1999, and a test rate of 6 percent, compounded annually, for the contingent payments due on December 31, 2000, and December 31, 2001.

Example 2. Fixed but deferred payment—(i) *Facts*. The facts are the same as in paragraph (c)(7) *Example 1* of this section, except that the contingent payment of interest that is fixed on December 31, 1997, is not payable until December 31, 2001, the maturity date.

(ii) *Treatment of deferred contingent payment*. Assume that the amount of the payment that becomes fixed on December 31, 1997, is $200,000. Because this amount is not payable until December 31, 2001, under paragraph (c)(4)(iii) of this section, a separate debt instrument to which section 1274 applies is treated as issued by B on December 31, 1997 (the date the payment is fixed). The maturity date of this separate debt instrument is December 31, 2001 (the date on which the payment is due). The stated principal amount of this separate debt instrument is $200,000, the amount of the payment that becomes fixed. The imputed principal amount of the separate debt instrument is $158,419, which is the present value, as of December 31, 1997, of the $200,000 payment, computed using a discount rate equal to the test rate of the overall debt instrument (6 percent, compounded annually). An amount equal to the issue price of the separate debt instrument is treated as an amount paid on December 31, 1997, and characterized as interest and principal under the rules of paragraph (c)(4)(ii) of this section. The amount of the deemed payment characterized as principal is equal to $150,875, which is the present value, as of January 1, 1997 (the issue date of the overall debt instrument), of the deemed payment, computed using a discount rate of 5 percent, compounded annually. The amount of the deemed payment characterized as interest is $7,544 ($158,419 – $150,875), which is includible in gross income by A and deductible by B in their respective taxable years in which December 31, 1997 occurs.

(d) *Rules for tax-exempt obligations*—(1) *In general*. Except as modified by this paragraph (d), the noncontingent bond method described in paragraph (b) of this section applies to a tax-exempt obligation (as defined in section 1275(a)(3)) to which this section applies. Paragraph (d)(2) of this section applies to certain tax-exempt obligations that provide for interest-based payments or revenue-based payments and paragraph (d)(3) of this section applies to all other obligations. Paragraph (d)(4) of this section provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation.

(2) *Certain tax-exempt obligations with interest-based or revenue-based payments*—(i) *Applicability*. This paragraph (d)(2) applies to a tax-exempt obligation that provides for interest-based payments or revenue-based payments.

(ii) *Interest-based payments*. A tax-exempt obligation provides for interest-based payments if the obligation would otherwise qualify as a variable rate debt instrument under §1.1275–5 except that—

(A) The obligation provides for more than one fixed rate;

(B) The obligation provides for one or more caps, floors, or governors (or similar restrictions) that are fixed as of the issue date;

(C) The interest on the obligation is not compounded or paid at least annually; or

(D) The obligation provides for interest at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, or at one or more rates equal to the product of a qualified floating rate and a fixed multiple greater than zero and less than .65, increased or decreased by a fixed rate.

(iii) *Revenue-based payments*. A tax-exempt obligation provides for revenue-based payments if the obligation—

(A) Is issued to refinance (including a series of refinancings) an obligation (in a series of refinancings, the original obligation), the proceeds of which were used to finance a project or enterprise; and

(B) Would otherwise qualify as a variable rate debt instrument under §1.1275–5 except that it provides for stated interest payments at least annually based on a single fixed percentage of the revenue, value, change in value, or other similar measure of the performance of the refinanced project or enterprise.

(iv) *Modifications to the noncontingent bond method*. If a tax-exempt obligation is subject to this paragraph (d)(2), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Daily portions and net positive adjustments*. The daily portions of interest determined under paragraph (b)(3)(iii) of this section and any net positive adjustment on the obligation are interest for purposes of section 103.

(B) *Net negative adjustments*. A net negative adjustment for a taxable year reduces the amount of tax-exempt interest the holder would otherwise account for on the obligation for the taxable year under paragraph (b)(3)(iii) of this section. If the net negative adjustment exceeds this amount, the excess is a nondeductible, noncapitalizable loss. If a regulated investment company (RIC) within the meaning of section 851 has a net negative adjustment in a taxable year that would be a nondeductible, noncapitalizable loss under the prior sentence, the RIC must use this loss to reduce its tax-exempt interest income on other tax-exempt obligations held during the taxable year.

(C) *Gains*. Any gain recognized on the sale, exchange, or retirement of the obligation is gain from the sale or exchange of the obligation.

(D) *Losses*. Any loss recognized on the sale, exchange, or retirement of the obligation is treated the same as a net negative adjustment under paragraph (d)(2)(iv)(B) of this section.

(E) *Special rule for losses and net negative adjustments*. Notwithstanding paragraphs (d)(2)(iv)(B) and (D) of this section, on the sale, exchange, or retirement of the obligation, the holder may claim a loss from the sale or exchange of the obligation to the extent the holder has not received in cash or property the sum of its original investment in the obligation and any amounts included in income under paragraph (d)(4)(ii) of this section.

(3) *All other tax-exempt obligations*—(i) *Applicability*. This paragraph (d)(3) applies to a tax-exempt obligation that is not subject to paragraph (d)(2) of this section.

(ii) *Modifications to the noncontingent bond method*. If a tax-exempt obligation is subject to this paragraph (d)(3), the following modifications to the noncontingent bond method described in paragraph (b) of this section apply to the obligation.

(A) *Modification to projected payment schedule*. The comparable yield for the obligation is the greater of the obligation's yield, determined without regard to the contingent payments, and the tax-exempt applicable Federal rate that applies to the obligation. The Internal Revenue Service publishes the tax-exempt applicable Federal rate for each month in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

(B) *Daily portions*. The daily portions of interest determined under paragraph (b)(3)(iii) of this section are interest for purposes of section 103.

(C) *Adjustments*. A net positive adjustment on the obligation is treated as gain to the holder from the sale or exchange of the obligation in the taxable year of the adjustment. A net negative adjustment on the obligation is treated as a loss to the holder from the sale or exchange of the obligation in the taxable year of the adjustment.

(D) *Gains and losses*. Any gain or loss recognized on the sale, exchange, or retirement of the obligation is gain or loss from the sale or exchange of the obligation.

(4) *Basis different from adjusted issue price*. This paragraph (d)(4) provides rules for a holder whose basis in a tax-exempt obligation is different from the adjusted issue price of the obligation. The rules of paragraph (b)(9)(i) of this section do not apply to tax-exempt obligations.

(i) *Basis greater than adjusted issue price*. If the holder's basis in the obligation exceeds the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is not deductible by the holder. However, the holder's basis in the obligation is reduced by the amount allocated to a daily portion of interest on the date the daily portion accrues.

(ii) *Basis less than adjusted issue price*. If the holder's basis in the obligation is less than the obligation's adjusted issue price, the holder, upon acquiring the obligation, must allocate this difference to daily portions of interest on a yield to maturity basis over the remaining term of the obligation. The amount allocated to a daily portion of interest is includible in income by the holder as ordinary income on the date the daily portion accrues. The holder's adjusted basis in the obligation is increased by the amount includible in income by the holder under this paragraph (d)(4)(ii) on the date the daily portion accrues.

(iii) *Premium and discount rules do not apply*. The rules for accruing premium and discount in sections 171, 1276, and 1288 do not apply. Other rules of those sections continue to apply to the extent relevant.

(e) *Amounts treated as interest under this section*. Amounts treated as interest under this section are treated as OID for all purposes of the Internal Revenue Code.

(f) *Effective date*. This section applies to debt instruments issued on or after August 13, 1996.

Par. 16. Section 1.1275–5 is amended by:

1. Revising paragraph (a)(1).

2. Removing the language ''The debt instrument must provide for stated interest'' from the introductory language of paragraph (a)(3)(i) and adding the language ''The debt instrument must not provide for any stated interest other than stated interest'' in its place.

3. Removing the language ''less than 1 year'' from the first sentence of paragraph (a)(3)(ii) and adding the language ''1 year or less'' in its place.

4. Adding paragraphs (a)(5) and (a)(6).

5. Revising paragraph (b)(2).

6. Revising paragraphs (c)(1) and (c)(5).

7. Removing the language ''cost of newly borrowed funds'' from paragraph (c)(3)(ii) and adding the language ''qualified floating rate'' in its place.

8. Revising paragraph (d) introductory text; revising *Examples 4* through *9*; and adding *Example 10*.

9. Revising paragraph (e)(2).

10. Revising paragraph (e)(3)(v) introductory text; revising *Example 3* (ii); and removing *Example 3* (iii).

The revisions and additions read as follows:

§1.1275–5 Variable rate debt instruments.

(a) *Applicability*—(1) *In general*. This section provides rules for variable rate debt instruments. Except as provided in paragraph (a)(6) of this section, a variable rate debt instrument is a debt instrument that meets the conditions described in paragraphs (a)(2), (3), (4), and (5) of this section. If a debt instrument that provides for a variable rate of interest does not qualify as a variable rate debt instrument, the debt instrument is a contingent payment debt instrument. See §1.1275–4 for the treatment of a contingent payment debt instrument. See §1.1275–6 for a taxpayer's treat-

ment of a variable rate debt instrument and a hedge.

* * * * * *

(5) *No contingent principal payments*. Except as provided in paragraph (a)(2) of this section, the debt instrument must not provide for any principal payments that are contingent (within the meaning of §1.1275–4(a)).

(6) *Special rule for debt instruments issued for nonpublicly traded property*. A debt instrument (other than a tax-exempt obligation) that would otherwise qualify as a variable rate debt instrument under this section is not a variable rate debt instrument if section 1274 applies to the instrument and any stated interest payments on the instrument are treated as contingent payments under §1.1274–2. This paragraph (a)(6) applies to debt instruments issued on or after August 13, 1996.

(b) * * *

(2) *Certain rates based on a qualified floating rate*. For a debt instrument issued on or after August 13, 1996, a variable rate is a qualified floating rate if it is equal to either—

(i) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35; or

(ii) The product of a qualified floating rate described in paragraph (b)(1) of this section and a fixed multiple that is greater than .65 but not more than 1.35, increased or decreased by a fixed rate.

* * * * * *

(c) *Objective rate*—(1) *Definition*—(i) *In general*. For debt instruments issued on or after August 13, 1996, an objective rate is a rate (other than a qualified floating rate) that is determined using a single fixed formula and that is based on objective financial or economic information. For example, an objective rate generally includes a rate that is based on one or more qualified floating rates or on the yield of actively traded personal property (within the meaning of section 1092(d)(1)).

(ii) *Exception*. For purposes of paragraph (c)(1)(i) of this section, an objective rate does not include a rate based on information that is within the control of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)) or that is unique to the circumstances of the issuer (or a related party within the meaning of section 267(b) or 707(b)(1)), such as dividends, profits, or the value of the issuer's stock. However, a rate does not fail to be an objective rate merely because it is based on the credit quality of the issuer.

* * * * * *

(5) *Tax-exempt obligations*. Notwithstanding paragraph (c)(1) of this section, in the case of a tax-exempt obligation (within the meaning of section 1275(a)(3)), a variable rate is an objective rate only if it is a qualified inverse floating rate or a qualified inflation rate. A rate is a qualified inflation rate if the rate measures contemporaneous changes in inflation based on a general inflation index.

(d) *Examples*. The following examples illustrate the rules of paragraphs (b) and (c) of this section. For purposes of these examples, assume that the debt instrument is not a tax-exempt obligation. In addition, unless otherwise provided, assume that the rate is not reasonably expected to result in a significant front-loading or back-loading of interest and that the rate is not based on objective financial or economic information that is within the control of the issuer (or a related party) or that is unique to the circumstances of the issuer (or a related party).

* * * * * *

Example 4. Rate based on changes in the value of a commodity index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to the percentage increase, if any, in the value of an index for the year immediately preceding the payment. The index is based on the prices of several actively traded commodities. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 5. Rate based on a percentage of S&P 500 Index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year based on a fixed percentage of the value of the S&P 500 Index. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds and, therefore, the rate is not a qualified floating rate. Although the rate is described in paragraph (c)(1)(i) of this section, the rate is not an objective rate because, based on historical data, it is reasonably expected that the average value of the rate during the first half of the instrument's term will be significantly less than the average value of the rate during the final half of the instrument's term.

Example 6. Rate based on issuer's profits. On January 1, 1997, Z issues a debt instrument that provides for annual interest payments equal to 1 percent of Z's gross profits earned during the year immediately preceding the payment. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. In addition, because the rate is based on information that is unique to the issuer's circumstances, the rate is not an objective rate.

Example 7. Rate based on a multiple of an interest index. On January 1, 1997, Z issues a debt instrument with annual interest payments at a rate equal to two times the value of 1-year LIBOR as of the payment date. Because the rate is a multiple greater than 1.35 times a qualified floating rate, the rate is not a qualified floating rate. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 8. Variable rate based on the cost of borrowed funds in a foreign currency. On January 1, 1997, Y issues a 5-year dollar denominated debt instrument that provides for annual interest payments at a rate equal to the value of 1-year French franc LIBOR as of the payment date. Variations in the value of French franc LIBOR do not measure contemporaneous changes in the cost of newly borrowed funds in dollars. As a result, the rate is not a qualified floating rate for an instrument denominated in dollars. However, because the rate is based on objective financial information using a single fixed formula, the rate is an objective rate.

Example 9. Qualified inverse floating rate. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 12 percent minus the value of 1-year LIBOR as of the payment date. On the issue date, the value of 1-year LIBOR is 6 percent. Because the rate can reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR, it is a qualified inverse floating rate. However, if the value of 1-year LIBOR on the issue date were 11 percent rather than 6 percent, the rate would not be a qualified inverse floating rate because the rate could not reasonably be expected to inversely reflect contemporaneous variations in 1-year LIBOR.

Example 10. Rate based on an inflation index. On January 1, 1997, X issues a debt instrument that provides for annual interest payments at the end of each year at a rate equal to 400 basis points (4 percent) plus the annual percentage change in a general inflation index (*e.g.,* the Consumer Price Index, U.S. City Average, All Items, for all Urban Consumers, seasonally unadjusted). The rate, however, may not be less than zero. Variations in the value of this interest rate cannot reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds. Accordingly, the rate is not a qualified floating rate. However, because the rate is based on objective economic information using a single fixed formula, the rate is an objective rate.

(e) * * *

(2) *Variable rate debt instrument that provides for annual payments of interest at a single variable rate*. If a variable rate debt instrument provides

for stated interest at a single qualified floating rate or objective rate and the interest is unconditionally payable in cash or in property (other than debt instruments of the issuer), or will be constructively received under section 451, at least annually, the following rules apply to the instrument:

(i) All stated interest with respect to the debt instrument is qualified stated interest.

(ii) The amount of qualified stated interest and the amount of OID, if any, that accrues during an accrual period is determined under the rules applicable to fixed rate debt instruments by assuming that the variable rate is a fixed rate equal to—

(A) In the case of a qualified floating rate or qualified inverse floating rate, the value, as of the issue date, of the qualified floating rate or qualified inverse floating rate; or

(B) In the case of an objective rate (other than a qualified inverse floating rate), a fixed rate that reflects the yield that is reasonably expected for the debt instrument.

(iii) The qualified stated interest allocable to an accrual period is increased (or decreased) if the interest actually paid during an accrual period exceeds (or is less than) the interest assumed to be paid during the accrual period under paragraph (e)(2)(ii) of this section.

(3) * * *

(v) *Examples*. The following examples illustrate the rules in paragraphs (e)(2) and (3) of this section.

* * * * * *

Example 3. * * *

(ii) *Accrual of OID and qualified stated interest*. Under paragraph (e)(2) of this section, the variable rate debt instrument is treated as a 2-year debt instrument that has an issue price of $90,000, a stated principal amount of $100,000, and interest payments of $5,000 at the end of each year. The debt instrument has $10,000 of OID and the annual interest payments of $5,000 are qualified stated interest payments. Under §1.1272–1, the debt instrument has a yield of 10.82 percent, compounded annually. The amount of OID allocable to the first annual accrual period (assuming Z uses annual accrual periods) is $4,743.25 (($90,000 × .1082) – $5,000), and the amount of OID allocable to the second annual accrual period is $5,256.75 ($100,000 – $94,743.25). Under paragraph (e)(2)(iii) of this section, the $2,000 difference between the $7,000 interest payment actually made at maturity and the $5,000 interest payment assumed to be made at maturity under the equivalent fixed rate debt instrument is treated as additional qualified stated interest for the period.

* * * * * *

Par. 17. Section 1.1275–6 is added to read as follows:

§1.1275–6 Integration of qualifying debt instruments.

(a) *In general*. This section generally provides for the integration of a qualifying debt instrument with a hedge or combination of hedges if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. The integrated transaction is generally subject to the rules of this section rather than the rules to which each component of the transaction would be subject on a separate basis. The purpose of this section is to permit a more appropriate determination of the character and timing of income, deductions, gains, or losses than would be permitted by separate treatment of the components. The rules of this section affect only the taxpayer who holds (or issues) the qualifying debt instrument and enters into the hedge.

(b) *Definitions*—(1) *Qualifying debt instrument*. A qualifying debt instrument is any debt instrument (including an integrated transaction as defined in paragraph (c) of this section) other than—

(i) A tax-exempt obligation as defined in section 1275(a)(3);

(ii) A debt instrument to which section 1272(a)(6) applies (certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration); or

(iii) A debt instrument that is subject to §1.483–4 or §1.1275–4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(2) *Section 1.1275–6 hedge*—(i) *In general*. A §1.1275–6 hedge is any financial instrument (as defined in paragraph (b)(3) of this section) if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity (under the principles of section 1272), or the right to the combined cash flows would qualify under §1.1275–5 as a variable rate debt instrument that pays interest at a qualified floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument is not a §1.1275–6 hedge, however, if the resulting synthetic debt instrument does not have the same term as the remaining term of the qualifying debt instrument. A financial instrument that hedges currency risk is not a §1.1275–6 hedge.

(ii) *Limitations*—(A) A debt instrument issued by a taxpayer and a debt instrument held by the taxpayer cannot be part of the same integrated transaction.

(B) A debt instrument can be a §1.1275–6 hedge only if it is issued substantially contemporaneously with, and has the same maturity (including rights to accelerate or delay payments) as, the qualifying debt instrument.

(3) *Financial instrument*. For purposes of this section, a financial instrument is a spot, forward, or futures contract, an option, a notional principal contract, a debt instrument, or a similar instrument, or combination or series of financial instruments. Stock is not a financial instrument for purposes of this section.

(4) *Synthetic debt instrument*. The synthetic debt instrument is the hypothetical debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and the §1.1275–6 hedge.

(c) *Integrated transaction*—(1) *Integration by taxpayer*. Except as otherwise provided in this section, a qualifying debt instrument and a §1.1275–6 hedge are an integrated transaction if all of the following requirements are satisfied:

(i) The taxpayer satisfies the identification requirements of paragraph (e) of this section on or before the date the taxpayer enters into the §1.1275–6 hedge.

(ii) None of the parties to the §1.1275–6 hedge are related within the meaning of section 267(b) or 707(b)(1), or, if the parties are related, the party providing the hedge uses, for federal income tax purposes, a mark-to-market method of accounting for the hedge and all similar or related transactions.

(iii) Both the qualifying debt instrument and the §1.1275–6 hedge are entered into by the same individual, partnership, trust, estate, or corporation (regardless of whether the corporation is a member of an affiliated group of corporations that files a consolidated return).

(iv) If the taxpayer is a foreign person engaged in a U.S. trade or

business and the taxpayer issues or acquires a qualifying debt instrument, or enters into a §1.1275–6 hedge, through the trade or business, all items of income and expense associated with the qualifying debt instrument and the §1.1275–6 hedge (other than interest expense that is subject to §1.882–5) would have been effectively connected with the U.S. trade or business throughout the term of the qualifying debt instrument had this section not applied.

(v) Neither the qualifying debt instrument, nor any other debt instrument that is part of the same issue as the qualifying debt instrument, nor the §1.1275–6 hedge was, with respect to the taxpayer, part of an integrated transaction that was terminated or otherwise legged out of within the 30 days immediately preceding the date that would be the issue date of the synthetic debt instrument.

(vi) The qualifying debt instrument is issued or acquired by the taxpayer on or before the date of the first payment on the §1.1275–6 hedge, whether made or received by the taxpayer (including a payment made to purchase the hedge). If the qualifying debt instrument is issued or acquired by the taxpayer after, but substantially contemporaneously with, the date of the first payment on the §1.1275–6 hedge, the qualifying debt instrument is treated, solely for purposes of this paragraph (c)(1)(vi), as meeting the requirements of the preceding sentence.

(vii) Neither the §1.1275–6 hedge nor the qualifying debt instrument was, with respect to the taxpayer, part of a straddle (as defined in section 1092(c)) prior to the issue date of the synthetic debt instrument.

(2) *Integration by Commissioner*. The Commissioner may treat a qualifying debt instrument and a financial instrument (whether entered into by the taxpayer or by a related party) as an integrated transaction if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a §1.1275–6 hedge. The Commissioner, however, may not integrate a transaction unless the qualifying debt instrument either is subject to §1.1275–4 or is subject to §1.1275–5 and pays interest at an objective rate. The circumstances under which the Commissioner may require integration include, but are not limited to, the following:

(i) A taxpayer fails to identify a qualifying debt instrument and the §1.1275–6 hedge under paragraph (e) of this section.

(ii) A taxpayer issues or acquires a qualifying debt instrument and a related party (within the meaning of section 267(b) or 707(b)(1)) enters into the §1.1275–6 hedge.

(iii) A taxpayer issues or acquires a qualifying debt instrument and enters into the §1.1275–6 hedge with a related party (within the meaning of section 267(b) or 707(b)(1)).

(iv) The taxpayer legs out of an integrated transaction and within 30 days enters into a new §1.1275–6 hedge with respect to the same qualifying debt instrument or another debt instrument that is part of the same issue.

(d) *Special rules for legging into and legging out of an integrated transaction*—(1) *Legging into*—(i) *Definition*. Legging into an integrated transaction under this section means that a §1.1275–6 hedge is entered into after the date the qualifying debt instrument is issued or acquired by the taxpayer, and the requirements of paragraph (c)(1) of this section are satisfied on the date the §1.1275–6 hedge is entered into (the leg-in date).

(ii) *Treatment*. If a taxpayer legs into an integrated transaction, the taxpayer treats the qualifying debt instrument under the applicable rules for taking interest and OID into account up to the leg-in date, except that the day before the leg-in date is treated as the end of an accrual period. As of the leg-in date, the qualifying debt instrument is subject to the rules of paragraph (f) of this section.

(iii) *Anti-abuse rule*. If a taxpayer legs into an integrated transaction with a principal purpose of deferring or accelerating income or deductions on the qualifying debt instrument, the Commissioner may—

(A) Treat the qualifying debt instrument as sold for its fair market value on the leg-in date; or

(B) Refuse to allow the taxpayer to integrate the qualifying debt instrument and the §1.1275–6 hedge.

(2) *Legging out*—(i) *Definition*—(A) *Legging out if the taxpayer has integrated*. If a taxpayer has integrated a qualifying debt instrument and a §1.1275–6 hedge under paragraph (c)(1) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the §1.1275–6 hedge ceases to meet the requirements for a §1.1275–6 hedge, the taxpayer fails to meet any requirement of paragraph (c)(1) of this section, or the taxpayer disposes of or otherwise terminates all or a part of the qualifying debt instrument or §1.1275–6 hedge. If the taxpayer fails to meet the requirements of paragraph (c)(1) of this section but meets the requirements of paragraph (c)(2) of this section, the Commissioner may treat the taxpayer as not legging out.

(B) *Legging out if the Commissioner has integrated*. If the Commissioner has integrated a qualifying debt instrument and a financial instrument under paragraph (c)(2) of this section, legging out means that, prior to the maturity of the synthetic debt instrument, the requirements for Commissioner integration under paragraph (c)(2) of this section are not met or the taxpayer fails to meet the requirements for taxpayer integration under paragraph (c)(1) of this section and the Commissioner agrees to allow the taxpayer to be treated as legging out.

(C) *Exception for certain nonrecognition transactions*. If, in a single nonrecognition transaction, a taxpayer disposes of, or ceases to be primarily liable on, the qualifying debt instrument and the §1.1275–6 hedge, the taxpayer is not treated as legging out. Instead, the integrated transaction is treated under the rules governing the nonrecognition transaction. For example, if a holder of an integrated transaction is acquired in a reorganization under section 368(a)(1)(A), the holder is treated as disposing of the synthetic debt instrument in the reorganization rather than legging out. If the successor holder is not eligible for integrated treatment, the successor is treated as legging out.

(ii) *Operating rules*. If a taxpayer legs out (or is treated as legging out) of an integrated transaction, the following rules apply:

(A) The transaction is treated as an integrated transaction during the time the requirements of paragraph (c)(1) or (2) of this section, as appropriate, are satisfied.

(B) Immediately before the taxpayer legs out, the taxpayer is treated as selling or otherwise terminating the

synthetic debt instrument for its fair market value and, except as provided in paragraph (d)(2)(ii)(D) of this section, any income, deduction, gain, or loss is realized and recognized at that time.

(C) If, immediately after the taxpayer legs out, the taxpayer holds or remains primarily liable on the qualifying debt instrument, adjustments are made to reflect any difference between the fair market value of the qualifying debt instrument and the adjusted issue price of the qualifying debt instrument. If, immediately after the taxpayer legs out, the taxpayer is a party to a §1.1275–6 hedge, the §1.1275–6 hedge is treated as entered into at its fair market value.

(D) If a taxpayer legs out of an integrated transaction by disposing of or otherwise terminating a §1.1275–6 hedge within 30 days of legging into the integrated transaction, then any loss or deduction determined under paragraph (d)(2)(ii)(B) of this section is not allowed. Appropriate adjustments are made to the qualifying debt instrument for any disallowed loss. The adjustments are taken into account on a yield to maturity basis over the remaining term of the qualifying debt instrument.

(E) If a holder of a debt instrument subject to §1.1275–4 legs into an integrated transaction with respect to the instrument and subsequently legs out of the integrated transaction, any gain recognized under paragraph (d)(2)(ii)(B) or (C) of this section is treated as interest income to the extent determined under the principles of §1.1275–4(b)(8)(iii)(B) (rules for determining the character of gain on the sale of a debt instrument all of the payments on which have been fixed). If the synthetic debt instrument would qualify as a variable rate debt instrument, the equivalent fixed rate debt instrument determined under §1.1275–5(e) is used for this purpose.

(e) *Identification requirements*. For each integrated transaction, a taxpayer must enter and retain as part of its books and records the following information—

(1) The date the qualifying debt instrument was issued or acquired (or is expected to be issued or acquired) by the taxpayer and the date the §1.1275–6 hedge was entered into by the taxpayer;

(2) A description of the qualifying debt instrument and the §1.1275–6 hedge; and

(3) A summary of the cash flows and accruals resulting from treating the qualifying debt instrument and the §1.1275–6 hedge as an integrated transaction (*i.e.,* the cash flows and accruals on the synthetic debt instrument).

(f) *Taxation of integrated transactions*—(1) *General rule*. An integrated transaction is generally treated as a single transaction by the taxpayer during the period that the transaction qualifies as an integrated transaction. Except as provided in paragraph (f)(12) of this section, while a qualifying debt instrument and a §1.1275–6 hedge are part of an integrated transaction, neither the qualifying debt instrument nor the §1.1275–6 hedge is subject to the rules that would apply on a separate basis to the debt instrument and the §1.1275–6 hedge, including section 1092 or §1.446–4. The rules that would govern the treatment of the synthetic debt instrument generally govern the treatment of the integrated transaction. For example, the integrated transaction may be subject to section 263(g) or, if the synthetic debt instrument would be part of a straddle, section 1092. Generally, the synthetic debt instrument is subject to sections 163(e) and 1271 through 1275, with terms as set forth in paragraphs (f)(2) through (13) of this section.

(2) *Issue date*. The issue date of the synthetic debt instrument is the first date on which the taxpayer entered into all of the components of the synthetic debt instrument.

(3) *Term*. The term of the synthetic debt instrument is the period beginning on the issue date of the synthetic debt instrument and ending on the maturity date of the qualifying debt instrument.

(4) *Issue price*. The issue price of the synthetic debt instrument is the adjusted issue price of the qualifying debt instrument on the issue date of the synthetic debt instrument. If, as a result of entering into the §1.1275–6 hedge, the taxpayer pays or receives one or more payments that are substantially contemporaneous with the issue date of the synthetic debt instrument, the payments reduce or increase the issue price as appropriate.

(5) *Adjusted issue price*. In general, the adjusted issue price of the synthetic debt instrument is determined under the principles of §1.1275–1(b).

(6) *Qualified stated interest*. No amounts payable on the synthetic debt instrument are qualified stated interest within the meaning of §1.1273–1(c).

(7) *Stated redemption price at maturity*—(i) *Synthetic debt instruments that are borrowings*. In general, if the synthetic debt instrument is a borrowing, the instrument's stated redemption price at maturity is the sum of all amounts paid or to be paid on the qualifying debt instrument and the §1.1275–6 hedge, reduced by any amounts received or to be received on the §1.1275–6 hedge.

(ii) *Synthetic debt instruments that are held by the taxpayer*. In general, if the synthetic debt instrument is held by the taxpayer, the instrument's stated redemption price at maturity is the sum of all amounts received or to be received by the taxpayer on the qualifying debt instrument and the §1.1275–6 hedge, reduced by any amounts paid or to be paid by the taxpayer on the §1.1275–6 hedge.

(iii) *Certain amounts ignored*. For purposes of this paragraph (f)(7), if an amount paid or received on the §1.1275–6 hedge is taken into account under paragraph (f)(4) of this section to determine the issue price of the synthetic debt instrument, the amount is not taken into account to determine the synthetic debt instrument's stated redemption price at maturity.

(8) *Source of interest income and allocation of expense*. The source of interest income from the synthetic debt instrument is determined by reference to the source of income of the qualifying debt instrument under sections 861(a)(1) and 862(a)(1). For purposes of section 904, the character of interest from the synthetic debt instrument is determined by reference to the character of the interest income from the qualifying debt instrument. Interest expense is allocated and apportioned under regulations under section 861 or under §1.882–5.

(9) *Effectively connected income*. If the requirements of paragraph (c)(1)(iv) of this section are satisfied, any interest income resulting from the synthetic debt instrument entered into by the foreign person is treated as effectively connected with a U.S. trade or business, and any interest expense resulting from the synthetic debt instrument entered into by the foreign person is allocated and apportioned under §1.882–5.

(10) *Not a short-term obligation*. For purposes of section 1272(a)(2)(C), a synthetic debt instrument is not treated as a short-term obligation.

(11) *Special rules in the event of integration by the Commissioner*. If the Commissioner requires integration, appropriate adjustments are made to the treatment of the synthetic debt instrument, and, if necessary, the qualifying debt instrument and financial instrument. For example, the Commissioner may treat a financial instrument that is not a §1.1275–6 hedge as a §1.1275–6 hedge when applying the rules of this section. The issue date of the synthetic debt instrument is the date determined appropriate by the Commissioner to require integration.

(12) *Retention of separate transaction rules for certain purposes*. This paragraph (f)(12) provides for the retention of separate transaction rules for certain purposes. In addition, by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter), the Commissioner may require use of separate transaction rules for any aspect of an integrated transaction.

(i) *Foreign persons that enter into integrated transactions giving rise to U.S. source income not effectively connected with a U.S. trade or business*. If a foreign person enters into an integrated transaction that gives rise to U.S. source interest income (determined under the source rules for the synthetic debt instrument) not effectively connected with a U.S. trade or business of the foreign person, paragraph (f) of this section does not apply for purposes of sections 871(a), 881, 1441, 1442, and 6049. These sections of the Internal Revenue Code are applied to the qualifying debt instrument and the §1.1275–6 hedge on a separate basis.

(ii) *Relationship between taxpayer and other persons*. Because the rules of this section affect only the taxpayer that enters into an integrated transaction (*i.e.,* either the issuer or a particular holder of a qualifying debt instrument), any provisions of the Internal Revenue Code or regulations that govern the relationship between the taxpayer and any other person are applied on a separate basis. For example, taxpayers must comply with any reporting or disclosure requirements on any qualifying debt instrument as if it were not part of an integrated transaction. Thus, if required under §1.1275–4(b)(4), an issuer of a contingent payment debt instrument subject to integrated treatment must provide the projected payment schedule to holders. Similarly, if a U.S. corporation enters into an integrated transaction that includes a notional principal contract, the source of any payment received by the counterparty on the notional principal contract is determined under §1.863–7 as if the contract were not part of an integrated transaction, and, if received by a foreign person who is not engaged in a U.S. trade or business, the payment is non-U.S. source income that is not subject to U.S. withholding tax.

(13) *Coordination with consolidated return rules*. If a taxpayer enters into a §1.1275–6 hedge with a member of the same consolidated group (the counterparty) and the §1.1275–6 hedge is part of an integrated transaction for the taxpayer, the §1.1275–6 hedge is not treated as an intercompany transaction for purposes of §1.1502–13. If the taxpayer legs out of integrated treatment, the taxpayer and the counterparty are each treated as disposing of its position in the §1.1275–6 hedge under the principles of paragraph (d)(2) of this section. If the §1.1275–6 hedge remains in existence after the leg-out date, the §1.1275–6 hedge is treated under the rules that would otherwise apply to the transaction (including §1.1502–13 if the transaction is between members).

(g) *Predecessors and successors*. For purposes of this section, any reference to a taxpayer, holder, issuer, or person includes, where appropriate, a reference to a predecessor or successor. For purposes of the preceding sentence, a predecessor is a transferor of an asset or liability (including an integrated transaction) to a transferee (the successor) in a nonrecognition transaction. Appropriate adjustments, if necessary, are made in the application of this section to predecessors and successors.

(h) *Examples*. The following examples illustrate the provisions of this section. In each example, assume that the qualifying debt instrument is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the debt instrument is a debt instrument for federal income tax purposes.

Example 1. Issuer hedge—(i) *Facts*. On January 1, 1997, V, a domestic corporation, issues a 5-year debt instrument for $1,000. The debt instrument provides for annual payments of interest at a rate equal to the value of 1-year LIBOR and a principal payment of $1,000 at maturity. On the same day, V enters into a 5-year interest rate swap agreement with an unrelated party. Under the swap, V pays 6 percent and receives 1-year LIBOR on a notional principal amount of $1,000. The payments on the swap are fixed and made on the same days as the payments on the debt instrument. On January 1, 1997, V identifies the debt instrument and the swap as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration*. The debt instrument is a qualifying debt instrument. The swap is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. V has met the identification requirements, and the other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument*. The synthetic debt instrument is a 5-year debt instrument that has an issue price of $1,000 and provides for annual interest payments of $60 and a principal payment of $1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument has a stated redemption price at maturity of $1,300 (the sum of all amounts to be paid on the qualifying debt instrument and the swap, reduced by amounts to be received on the swap). The synthetic debt instrument, therefore, has $300 of OID.

Example 2. Issuer hedge with an option—(i) *Facts*. On December 31, 1996, W, a domestic corporation, issues for $1,000 a debt instrument that matures on December 31, 1999. The debt instrument has a stated principal amount of $1,000 payable at maturity. The debt instrument also provides for a payment at maturity equal to $10 times the increase, if any, in the value of a nationally known composite index of stocks from December 31, 1996, to the maturity date. On December 31, 1996, W purchases from an unrelated party an option that pays $10 times the increase, if any, in the stock index from December 31, 1996, to December 31, 1999. W pays $250 for the option. On December 31, 1996, W identifies the debt instrument and option as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration*. The debt instrument is a qualifying debt instrument. The option is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the option and the debt instrument can be calculated. W has met the identification requirements, and the other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument*. Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument ($1,000) reduced by the payment for the option ($250). As a result, the synthetic debt instrument is a 3-year debt instrument with an issue price of $750. Under paragraph (f)(7) of this section, the synthetic debt instrument has a stated redemption price at maturity of $1,000 (the $250 payment for the option is not taken into account). The synthetic debt instrument, therefore, has $250 of OID.

Example 3. Hedge with prepaid swap—(i) *Facts*. On January 1, 1997, H purchases for

£1,000 a 5-year debt instrument that provides for semiannual payments based on 6-month pound LIBOR and a payment of the £1,000 principal at maturity. On the same day, H enters into a swap with an unrelated third party under which H receives semiannual payments, in pounds, of 10 percent, compounded semiannually, and makes semiannual payments, in pounds, of 6-month pound LIBOR on a notional principal amount of £1,000. Payments on the swap are fixed and made on the same dates as the payments on the debt instrument. H also makes a £162 prepayment on the swap. On January 1, 1997, H identifies the swap and the debt instrument as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration*. The debt instrument is a qualifying debt instrument. The swap is a §1.1275–6 hedge because it is a financial instrument and a yield to maturity on the combined cash flows of the swap and the debt instrument can be calculated. Although the debt instrument is denominated in pounds, the swap hedges only interest rate risk, not currency risk. Therefore, the transaction is an integrated transaction under this section. See §1.988–5(a) for the treatment of a debt instrument and a swap if the swap hedges currency risk.

(iii) *Treatment of the synthetic debt instrument*. Under paragraph (f)(4) of this section, the issue price of the synthetic debt instrument is equal to the issue price of the debt instrument (£1,000) increased by the prepayment on the swap (£162). As a result, the synthetic debt instrument is a 5-year debt instrument that has an issue price of £1,162 and provides for semiannual interest payments of £50 and a principal payment of £1,000 at maturity. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is £1,500 (the sum of all amounts to be received on the qualifying debt instrument and the §1.1275–6 hedge, reduced by all amounts to be paid on the §1.1275–6 hedge other than the £162 prepayment for the swap). The synthetic debt instrument, therefore, has £338 of OID.

Example 4. Legging into an integrated transaction by a holder—(i) *Facts*. On December 31, 1996, X corporation purchases for $1,000,000 a debt instrument that matures on December 31, 2006. The debt instrument provides for annual payments of interest at the rate of 6 percent and for a payment at maturity equal to $1,000,000, increased by the excess, if any, of the price of 1,000 units of a commodity on December 31, 2006, over $350,000, and decreased by the excess, if any, of $350,000 over the price of 1,000 units of the commodity on that date. The projected amount of the payment at maturity determined under §1.1275–4(b)(4) is $1,020,000. On December 31, 1999, X enters into a cash-settled forward contract with an unrelated party to sell 1,000 units of the commodity on December 31, 2006, for $450,000. On December 31, 1999, X also identifies the debt instrument and the forward contract as an integrated transaction in accordance with the requirements of paragraph (e) of this section.

(ii) *Eligibility for integration*. X meets the requirements for integration as of December 31, 1999. Therefore, X legged into an integrated transaction on that date. Prior to that date, X treats the debt instrument under the applicable rules of §1.1275–4.

(iii) *Treatment of the synthetic debt instrument*. As of December 31, 1999, the debt instrument and the forward contract are treated as an integrated transaction. The issue price of the synthetic debt instrument is equal to the adjusted issue price of the qualifying debt instrument on the leg-in date, $1,004,804 (assuming one year accrual periods). The term of the synthetic debt instrument is from December 31, 1999, to December 31, 2006. The synthetic debt instrument provides for annual interest payments of $60,000 and a principal payment at maturity of $1,100,000 ($1,000,000 + $450,000 – $350,000). Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(ii) of this section, the synthetic debt instrument's stated redemption price at maturity is $1,520,000 (the sum of all amounts to be received by X on the qualifying debt instrument and the §1.1275–6 hedge, reduced by all amounts to be paid by X on the §1.1275–6 hedge). The synthetic debt instrument, therefore, has $515,196 of OID.

Example 5. Abusive leg-in—(i) *Facts*. On January 1, 1997, Y corporation purchases for $1,000,000 a debt instrument that matures on December 31, 2001. The debt instrument provides for annual payments of interest at the rate of 6 percent, a payment on December 31, 1999, of the increase, if any, in the price of a commodity from January 1, 1997, to December 31, 1999, and a payment at maturity of $1,000,000 and the increase, if any, in the price of the commodity from December 31, 1999 to maturity. Because the debt instrument is a contingent payment debt instrument subject to §1.1275–4, Y accrues interest based on the projected payment schedule.

(ii) *Leg-in*. By late 1999, the price of the commodity has substantially increased, and Y expects a positive adjustment on December 31, 1999. In late 1999, Y enters into an agreement to exchange the two commodity based payments on the debt instrument for two payments on the same dates of $100,000 each. Y identifies the transaction as an integrated transaction in accordance with the requirements of paragraph (e) of this section. Y disposes of the hedge in early 2000.

(iii) *Treatment*. The legging into an integrated transaction has the effect of deferring the positive adjustment from 1999 to 2000. Because Y legged into the integrated transaction with a principal purpose to defer the positive adjustment, the Commissioner may treat the debt instrument as sold for its fair market value on the leg-in date or refuse to allow integration.

Example 6. Integration of offsetting debt instruments—(i) *Facts*. On January 1, 1997, Z issues two 10-year debt instruments. The first, Issue 1, has an issue price of $1,000, pays interest annually at 6 percent, and, at maturity, pays $1,000, increased by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and reduced by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. However, the amount paid at maturity may not be less than $500 or more than $1,500. The second, Issue 2, has an issue price of $1,000, pays interest annually at 8 percent, and, at maturity, pays $1,000, reduced by $1 times the increase, if any, in the value of the S&P 100 Index over the term of the instrument and increased by $1 times the decrease, if any, in the value of the S&P 100 Index over the term of the instrument. The amount paid at maturity may not be less than $500 or more than $1,500. On January 1, 1997, Z identifies Issue 1 as the qualifying debt instrument, Issue 2 as a §1.1275–6 hedge, and otherwise meets the identification requirements of paragraph (e) of this section.

(ii) *Eligibility for integration*. Both Issue 1 and Issue 2 are qualifying debt instruments. Z has met the identification requirements by identifying Issue 1 as the qualifying debt instrument and Issue 2 as the §1.1275–6 hedge. The other requirements of paragraph (c)(1) of this section are satisfied. Therefore, the transaction is an integrated transaction under this section.

(iii) *Treatment of the synthetic debt instrument*. The synthetic debt instrument has an issue price of $2,000, provides for a payment at maturity of $2,000, and, in addition, provides for annual payments of $140. Under paragraph (f)(6) of this section, no amounts payable on the synthetic debt instrument are qualified stated interest. Thus, under paragraph (f)(7)(i) of this section, the synthetic debt instrument's stated redemption price at maturity is $3,400 (the sum of all amounts to be paid on the qualifying debt instrument and the §1.1275–6 hedge, reduced by amounts to be received on the §1.1275–6 hedge other than the $1,000 payment received on the issue date). The synthetic debt instrument, therefore, has $1,400 of OID.

Example 7. Integrated transaction entered into by a foreign person—(i) *Facts*. X, a foreign person, enters into an integrated transaction by purchasing a qualifying debt instrument that pays U.S. source interest and entering into a notional principal contract with a U.S. corporation. Neither the income from the qualifying debt instrument nor the income from the notional principal contract is effectively connected with a U.S. trade or business. The notional principal contract is a §1.1275–6 hedge.

(ii) *Treatment of integrated transaction*. Under paragraph (f)(8) of this section, X will receive U.S. source income from the integrated transaction. However, under paragraph (f)(12)(i) of this section, the qualifying debt instrument and the notional principal contract are treated as if they are not part of an integrated transaction for purposes of determining whether tax is due and must be withheld on income. Accordingly, because the §1.1275–6 hedge would produce foreign source income under §1.863–7 to X if it were not part of an integrated transaction, any income on the §1.1275–6 hedge generally will not be subject to tax under sections 871(a) and 881, and the U.S. corporation that is the counterparty will not be required to withhold tax on payments under the §1.1275–6 hedge under sections 1441 and 1442.

(i) [Reserved]

(j) *Effective date*. This section applies to a qualifying debt instrument issued on or after August 13, 1996. This section also applies to a qualifying debt instrument acquired by the taxpayer on or after August 13, 1996, if—

(1) The qualifying debt instrument is a fixed rate debt instrument or a variable rate debt instrument; or

(2) The qualifying debt instrument and the §1.1275–6 hedge are acquired

by the taxpayer substantially contemporaneously.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 18. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 19. Section 602.101, paragraph (c) is amended by:

1. Removing the following entries from the table:

§602.101 OMB Control numbers.

* * * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control number
* * * * * *	
1.1272–1(c)(4)	1545–1353
* * * * * *	
1.1275–3(b)	1545–1353
1.1275–3(c)	1545–0887
* * * * * *	

2. Adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control number
* * * * * *	
1.1275–2(h)	1545–1450
1.1275–3	1545–0887
	1545–1353
	1545–1450
1.1275–4(b)	1545–1450
1.1275–6(e)	1545–1450
* * * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved March 22, 1996.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on June 11, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 14, 1996, 61 F.R. 30133)

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 4.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 4.

Section 7872.—Treatment of Loans with Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1996. See Rev. Rul. 96–34, page 4.

Subpart A.—Tax Conventions

LUXEMBOURG

EMBASSY OF THE UNITED STATES OF AMERICA
LUXEMBOURG
APRIL 11, 1989

The Embassy of the United States of America presents its compliments to the Ministry of Foreign Affairs of the Grand Duchy of Luxembourg and has the honor to propose that the two Governments conclude an agreement to exempt from income and capital tax, on a reciprocal basis, income derived and capital owned by residents of the other country in respect of the international operations of ships and aircraft. The terms of the agreement are as follows:

The Government of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax, gross income derived from the international operation of ships or aircraft by individuals who are residents of Luxembourg (other than U.S. citizens) and corporations organized in Luxembourg. This exemption is granted on the basis of equivalent exemptions granted by the Grand Duchy of Luxembourg to individual residents of the United States and to corporations organized in the United States (which are not subject to tax by Luxembourg on the basis of residence).

In the case of a Luxembourg corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(i) The corporation's stock is primarily and regularly traded on an established securities market in Luxembourg, another country which grants an equivalent exemption to U.S. corporations, or the United States; or

(ii) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Luxembourg or of another country which grants an equivalent exemption to U.S. corporations or by a corporation organized in a country which grants a reciprocal exemption to U.S. corporations and whose stock is primarily and regularly traded on an established securities market in that country, another country which grants an equivalent exemption to U.S. corporations, or the United States.

For purposes of subparagraph (ii), the Government of the Grand Duchy of Luxembourg will be treated as an individual resident of Luxembourg. For purposes of the exemption from U.S. tax, subparagraph (ii) will be considered to be satisfied if the corporation is a ''controlled foreign corporation'' under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

The Grand Duchy of Luxembourg agrees to exempt from income taxes on individuals and corporations and from communal tax on commercial profits income derived from the international operation of ships or aircraft by U.S. residents and corporations organized in the United States (other than corporations which are subject to tax by Luxembourg on the basis of residence).

The Grand Duchy of Luxembourg agrees to exempt from wealth tax and communal tax on invested capital, capital represented by ships or aircraft operated in international traffic and by movable property pertaining to the operation of such ships or aircraft.

In the case of a U.S. corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(i) the corporation's stock is primarily and regularly traded on an established securities market in the United States, another country which grants a reciprocal exemption to Luxembourg corporations, or the United States; or

(ii) more than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the United States or of another country which grants a reciprocal exemption to Luxembourg corporations or by a corporation organized in a country which grants a reciprocal exemption to Luxembourg corporations and whose stock is primarily and regularly traded on an established securities exchange in that country, another country which grants a reciprocal exemption to Luxembourg corporations or the United States.

Income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

This agreement will not affect the provisions of Article V of the Convention of December 18, 1962, between the United States of America and the Grand Duchy of Luxembourg with respect to taxes on income and property which will remain in effect.

This agreement shall enter into force upon the confirmation by the Embassy of the United States of America of the notification by the Government of the Grand Duchy of Luxembourg indicating that all necessary internal procedures have been completed and the exemption from taxes as provided for in paragraphs 1 and 2 shall have effect with respect to taxable years beginning on or after January 1, 1987.

Either government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Embassy of the United States of America takes this opportunity to renew to the Ministry of Foreign Affairs the assurances of its highest consideration.

GRAND DUCHY OF LUXEMBOURG
MINISTRY OF FOREIGN AFFAIRS
LUXEMBOURG
JUNE 22, 1989

The Ministry of Foreign Affairs of the Grand Duchy of Luxembourg presents its compliments to the Embassy of the United States of America and has the honor to acknowledge receipt of its note of 11 April 1989, proposing the

terms of an agreement for a reciprocal exemption from income and capital tax of income derived and capital owned in respect of the international operation of ships and aircraft. The terms of the agreement are as follow:

1. The Goverment of the United States of America, in accordance with sections 872(b) and 883(a) of the Internal Revenue Code, agrees to exempt from tax gross income derived from the international operation of ships or aircraft by individuals who are residents of Luxembourg (other than U.S. citizens) and corporations organized in Luxembourg. This exemption is granted on the basis of equivalent exemptions granted by the Grand Duchy of Luxembourg to individual residents of the United States and to corporations organized in the United States (which are not subject to tax by Luxembourg on the basis of residence).

In the case of a Luxembourg corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(i) The corporation's stock is primarily and regularly traded on an established securities market in Luxembourg, another country which grants an equivalent exemption to U.S. corporations, or the United States; or

(ii) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of Luxembourg or of another country which grants an equivalent exemption to U.S. corporations or by a corporation organized in a country which grants a reciprocal exemption to U.S. corporations and whose stock is primarily and regularly traded on an established securites market in that country, another country which grants an equivalent exemption to U.S. corporations, or the United States.

For purposes of subparagraph (ii), the Government of the Grand Duchy of Luxembourg will be treated as an individual resident of Luxembourg. For purposes of the exemption from U.S. tax, subparagraph (ii) will be considered to be satisfied if the corporation is a ''controlled foreign corporation'' under the Internal Revenue Code.

Gross income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

2. The Grand Duchy of Luxembourg agrees to exempt from income taxes on individuals and corporations and from communal tax on commercial profits income derived from the international operations of ships or aircraft by U.S. residents and corporations organized in the United States (other than corporations which are subject to tax by Luxembourg on the basis of residence).

The Grand Duchy of Luxembourg agrees to exempt from wealth tax and communal tax on invested capital, capital represented by ships or aircraft operated in international traffic and by movable property pertaining to the operation of such ships or aircraft.

In the case of a U.S. corporation, the exemption shall apply only if the corporation meets either of the following conditions:

(i) The corporation's stock is primarily and regularly traded on an established securities market in the United States, another country which grants a reciprocal exemption to Luxembourg corporations, or Luxembourg; or

(ii) More than 50 percent of the value of the corporation's stock is owned, directly or indirectly, by individuals who are residents of the United States or of another country which grants a reciprocal exemption to Luxembourg corporations or by a corporation organized in a country which grants a reciprocal exemption to Luxembourg corporations and whose stock is primarily and regularly traded on an established securities exchange in that country, another country which grants a reciprocal exemption to Luxembourg corporations or Luxembourg.

Income includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport.

3. This agreement will not affect the provisions of Article V of the Convention of December 18, 1962, between the United States of America and the Grand Duchy of Luxembourg with respect to taxes on income and property which will remain in effect.

4. This agreement shall enter into force upon the confirmation by the Embassy of the United States of America of the notification by the Government of the Grand Duchy of Luxembourg indicating that all necessary internal procedures have been completed and the exemption from taxes as provided for in paragraphs 1 and 2 shall have effect with respect to taxable years beginning on or after January 1, 1987.

5. Either Government may terminate this agreement by giving written notice of termination through diplomatic channels.

The Ministry of Foreign Affairs of the Grand Duchy of Luxembourg takes this opportunity to renew to the Embassy of the United States of America the assurances of his highest consideration.

Notice of Proposed Rulemaking and Notice of Public Hearing

Section 467 Rental Agreements

IA–292–84

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the treatment of rent and interest under certain agreements for the lease of tangible property. The proposed regulations apply to certain rental agreements that provide increasing or decreasing rents, or deferred or prepaid rent. This document also provides notice of a public hearing on these regulations.

DATES: Written comments, requests to appear and outlines of topics to be discussed at the public hearing scheduled for September 25, 1996, must be received by September 3, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (IA–292–84), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (IA–292–84), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the Commissioner's Conference Room, 3rd Floor, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Forest Boone of the Office of Assistant Chief Counsel (Income Tax and Accounting) at (202) 622-4960; concerning submissions and the public hearing, Mike Slaughter at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) relating to section 467 of the Internal Revenue Code (Code). This section was added by the Tax Reform Act of 1984. In general, section 467 requires parties to certain rental agreements to accrue rent and interest in accordance with the rules specified in section 467. These proposed regulations provide guidance regarding the applicability of section 467, and the amount of rent and interest required to be accrued under section 467. No inference should be drawn from any provision in the proposed regulations concerning whether an arrangement constitutes a lease for Federal income tax purposes.

Explanation of Provisions

1. *Section 467 rental agreements*

Section 467(a) provides that, if a rental agreement is a section 467 rental agreement, the lessor and lessee must take into account for a taxable year the section 467 rent and the section 467 interest for that year. A section 467 rental agreement is a rental agreement that has increasing or decreasing rents, or prepaid or deferred rents. A rental agreement has increasing or decreasing rents if the annualized fixed rent allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term. The proposed regulations provide that a rent holiday at the beginning of the lease term is disregarded in determining whether the rental agreement has increasing or decreasing rent if the rent holiday period is three months or less.

In addition, the proposed regulations provide that a rental agreement has increasing or decreasing rent if it requires (or may require) the payment of contingent rent, other than contingent rent that is contingent due to (a) a provision computing rent based on a percentage of the lessee's gross or net receipts (but only if the percentage does not vary throughout the term of the lease); (b) adjustments based on a reasonable price index; or (c) a provision requiring the lessee to pay real estate taxes, insurance premiums, maintenance costs, or any other cost (other than a debt service cost) that relates to the leased property and is not within the control of the lessor or lessee or a person related to the lessor or lessee.

Section 467(d)(1)(A) provides that a rental agreement has deferred rent if rent allocated to a calendar year is payable after the close of the succeeding calendar year. The proposed regulations provide that there is prepaid rent if rent allocated to a calendar year is payable prior to the beginning of the prior calendar year.

Section 467(d)(2) provides that section 467 does not apply to a rental agreement if the aggregate rental payments and other consideration to be received for the use of the property do not exceed $250,000.

2. *Section 467 rent*

Under the proposed regulations, the section 467 rent for a taxable year is the sum of the fixed rent for any rental periods that begin and end in the taxable year, a ratable portion of the fixed rent for other rental periods beginning or ending in the taxable year, and any contingent rent that accrues in the taxable year. In general, the proposed regulations provide that rental periods may be of any length as long as (a) the rental periods are one year or less, cover the entire lease term, and do not overlap, and (b) each scheduled payment under the rental agreement occurs within 30 days of the beginning or end of a rental period. The amount of fixed rent for a rental period depends on the terms of the rental agreement.

A. *Disqualified leaseback or long-term agreement*

Section 467 provides that if the section 467 rental agreement is a leaseback or long-term agreement and has increasing or decreasing rents a principal purpose of which is tax avoidance (a disqualified leaseback or long-term agreement), the fixed rent for each rental period is the constant rental amount. The proposed regulations provide that (a) the Commissioner, rather than the parties to the rental agreement, will determine whether a rental agreement is a disqualified leaseback or long-term agreement and (b) a rental agreement will not be disqualified unless it requires more than $2,000,000

in rental payments and other consideration. The proposed regulations also provide that, if either the lessor or the lessee is not subject to Federal income tax on its income or is a tax-exempt entity (within the meaning of section 168(h)(2)), the rental agreement will be closely scrutinized, and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent.

Section 467(b)(5) provides that regulations should set forth circumstances under which section 467 rental agreements will not be treated as disqualified leasebacks or long-term agreements, including circumstances relating to the use of price indices, percentage rents, reasonable rent holidays, or changes in amounts paid to third parties. In addition to these safe harbors, which have been included in the proposed regulations, the Conference Committee Report stated that the Committee anticipated that regulations under section 467 would adopt standards under which leases providing for fluctuations in rents by no more than a reasonable percentage above or below the average rent over the term of the lease will be deemed not motivated by tax avoidance. The report cited the standards for advance rulings on leveraged lease transactions set forth in Rev. Proc. 75–21 (1975–1 C.B. 715), and stated that such standards may not be appropriate for real estate leases. H.R. Rep. No. 861, 98th Cong., 2d Sess. 893 (1984).

The proposed regulations contain a safe harbor providing that tax avoidance will not be considered to be a principal purpose for providing increasing or decreasing rents if the rents allocable to each calendar year of the lease do not vary from the average annual rents over the entire lease term by more than 10 percent. This safe harbor is based on, but is not identical to, the safe harbor contained in Rev. Proc. 75–21. The proposed regulations do not provide a safe harbor specifically applicable to real estate leases. The IRS and the Treasury Department invite comments regarding the nature and extent of a safe harbor for such leases, as well as comments on whether additional safe harbors are appropriate either generally or for particular industries.

Section 467(e)(1) provides that the constant rental amount is the amount that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the disqualified leaseback or long-term agreement. If constant rental accrual is required, all rental periods must be equal in length except for an initial or final short rental period.

B. *Agreements without adequate interest*

If the section 467 rental agreement is not a disqualified leaseback or long-term agreement and does not provide adequate interest for prepaid or deferred rent, the proposed regulations provide that the fixed rent for each rental period is the proportional rental amount. The proportional rental amount is the fixed rent allocated to the rental period under the rental agreement multiplied by a fraction, the numerator of which is the present value of the amounts payable as fixed rent and interest on fixed rent under the rental agreement and the denominator of which is the present value of the fixed rent allocated to each rental period under the rental agreement. Under the proposed regulations, a rental agreement provides adequate interest if (a) no deferred or prepaid rent is required under the agreement, (b) there is deferred or prepaid rent but the agreement requires the payment of interest at an adequate single fixed rate, or (c) there is deferred or prepaid rent but the present values of rent payments and rent accruals meet certain tests set forth in the proposed regulations.

C. *Rental agreement accrual*

The proposed regulations provide that if neither the constant rental amount nor the proportional rental amount is required to be accrued, the fixed rent for a rental period is the fixed rent allocated to that rental period in accordance with the section 467 rental agreement. The amount of fixed rent allocated to a rental period by the rental agreement depends on whether the agreement provides a specific allocation of fixed rent. The proposed regulations provide that if a rental agreement provides a specific allocation of fixed rent, the amount of fixed rent allocated to each rental period during the lease term is the amount of rent allocated to that period by the agreement. For this purpose, a rental agreement that allocates rent to a period is treated as allocating rent ratably within that period. Thus, if a rental agreement provides that $120,000 is allocated to each calendar year in the lease term, $10,000 of rent is allocated to each calendar month. In general, under the proposed regulations, a rental agreement specifically allocates fixed rent if the agreement unambiguously specifies, for periods of no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period.

If a section 467 rental agreement does not provide a specific allocation of fixed rent, the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that rental period.

3. *Section 467 interest*

The section 467 interest for a taxable year is the sum of the interest on fixed rent for any rental period that begins and ends in the taxable year, a ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year, and any interest that accrues on contingent rent during the taxable year. If a section 467 rental agreement provides an adequate stated rate of interest, the interest on fixed rent for a rental period is the interest provided in the agreement for that period. If no adequate stated rate of interest is provided, the interest on fixed rent for a rental period is determined under the section 467 loan rules.

Under the proposed regulations, there is a deemed loan (a section 467 loan) in a rental period if, at the beginning of that period, there is a difference between the amount of fixed rent payable under the section 467 rental agreement and the amount of fixed rent required to be accrued under the proposed regulations. For rental periods in which there is a section 467 loan, the interest for the rental period is equal to the product of the principal balance of the section 467 loan at the beginning of the rental period and the yield of the section 467 loan.

In general, the principal balance of a section 467 loan as of the beginning of any rental period is the difference between the cumulative amount of accrued fixed rent and interest and the

cumulative amount of fixed rent and interest payable under the section 467 rental agreement. The yield of a section 467 loan is the discount rate at which the sum of the present values of all amounts payable by the lessee as fixed rent and interest on fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest on prepaid fixed rent, equals the sum of the present values of the fixed rent allocated to the rental periods.

The amount constituting a section 467 loan may be either positive or negative. For purposes of applying any aspect of the proposed regulations relating to a section 467 loan, the principal balance of the loan should be clearly identified as either positive or negative. For example, if the principal balance of a loan at the beginning of a rental period is a negative number, the interest on the loan for that period will also be a negative number.

4. *Rental agreements with variable rates of interest*

The proposed regulations provide rules for section 467 rental agreements that provide for certain types of variable rates of interest. The rules in the proposed regulations are similar to the rules provided in §1.1275–5 for the computation of original issue discount (OID) for variable rate debt instruments providing for interest at qualified floating rates. Under the proposed regulations, a rental agreement provides variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275–5(a)(3)(i)(A) or (B) and §1.1275–5(a)(4). If a rental agreement provides for fluctuations in interest other than pursuant to one or more qualified floating rates the interest will be subject to the rules for contingent payments.

Under the proposed regulations, if a section 467 rental agreement provides variable interest, the fixed rate substitutes (determined in the same manner as under §1.1275–5(e) treating the agreement date as the issue date) for the variable rates of interest called for by the agreement must be used in computing the proportional rental amount, the constant rental amount, the principal balance of a section 467 loan, and the yield of a section 467 loan. Further, in determining the interest on fixed rent for any rental period, the variable interest adjustment amount must be taken into account. The variable interest adjustment amount for a rental period is the difference between (a) the amount of interest that would have accrued during the rental period under the terms of the rental agreement, and (b) the amount of interest that would have accrued during the rental period under the terms of the agreement using the fixed rate substitutes.

5. *Rental agreements with contingent payments*

The proposed regulations reserve on the issue of the section 467 treatment of contingent rent. The IRS and the Treasury Department anticipate that regulations addressing this issue will provide rules for contingent rent similar to those provided for computing OID for contingent payment debt instruments in §1.1275–4. The IRS and the Treasury Department invite comments regarding the application of the §1.1275–4 rules to section 467 rental agreements.

6. *Recapture*

Section 467(c) provides that if a section 467 rental agreement is a leaseback or long-term agreement providing for increasing rent but is not subject to constant rental accrual, and the property subject to the agreement is disposed of, a portion of the gain realized on the disposition is required to be recaptured by the lessor as ordinary income. Accordingly, a leaseback or long-term agreement could be subject to section 467(c) even though it does not require more than $2,000,000 in rental payments and other consideration and is thus not subject to constant rental accrual.

The recapture amount is equal to the lesser of the prior understated inclusions or the section 467 gain. The prior understated inclusions are the excess of (a) the aggregate amount of section 467 rent and section 467 interest for the period during which the lessor held the property, determined as if the section 467 rental agreement were a disqualified leaseback or long-term agreement, over (b) the aggregate amount of section 467 rent and section 467 interest accrued by the lessor during that period. The section 467 gain is the excess of (a) the amount realized from the disposition, over (b) the sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under any provision of subtitle A of the Code other than section 467(c) (*e.g.,* section 1245 or 1250).

In the case of a disposition that is not a sale, exchange, or involuntary conversion, the section 467 gain is the excess of (a) the fair market value of the property on the date of disposition, over (b) the sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under Code provisions other than section 467(c). The regulations provide exceptions to this recapture rule for dispositions by gift, transfers at death, and certain tax-free transactions.

7. *Other disposition rules*

Under the proposed regulations, if property subject to a section 467 rental agreement is sold, exchanged, or otherwise disposed of, the section 467 rent for a period is taken into account by the owner of the property during the period. The lessee, however, must continue to take section 467 rent and section 467 interest into account without regard to the change of ownership.

Further, if there is a sale, exchange or other disposition of property subject to a section 467 rental agreement, the beginning balance of the transferor's section 467 loan after the transfer equals the net present value at the time of the transfer of all amounts subsequently payable as fixed rent and interest on fixed rent to the transferor and all amounts subsequently payable as interest on prepaid fixed rent by the transferor. The transferor must continue to take into account interest on the transferor's section 467 loan balance after the transfer. The beginning balance of the transferee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the transfer reduced by the beginning balance of the transferor's section 467 loan after the transfer. Amounts payable to the transferor after the transfer are not taken into account in adjusting the transferee's section 467 loan balance.

Finally, under the proposed regulations, if there is a disposition of

property subject to a section 467 rental agreement, the transferor and transferee must treat the beginning balance of the transferee's section 467 loan as a liability that is either assumed in connection with the transfer of the property or secured by the property acquired subject to the liability (if negative) and as a reduction in the consideration for the transfer of the property (if positive). In the case of a positive section 467 loan balance, a reduction in the consideration for the transfer of the property is appropriate because the transferee will also be deemed to have acquired an asset other than the property itself, i.e., the loan, and a portion of the total consideration should be allocated to the loan balance. Similar rules apply to transfers of leasehold interests under section 467 rental agreements.

In order to account for any timing differences that may exist between a schedule of payments under a section 467 rental agreement and a separate schedule providing an allocation of rent, it will be necessary, in appropriate cases, to determine the amount of a section 467 loan balance even if the rental agreement does not have either deferred or prepaid rent or if the rental agreement has deferred or prepaid rent but provides adequate stated interest. The proposed regulations provide that the section 467 loan rules apply to rental agreements described in the preceding sentence, but only for purposes of the rules relating to dispositions of property subject to a section 467 rental agreement and the rules relating to transfers of leasehold interests under a section 467 rental agreement.

Although the proposed regulations contain rules applicable to all dispositions of property subject to a section 467 rental agreement and all transfers of leasehold interests under a section 467 rental agreement, the regulations reserve guidance on the question of whether special rules should be provided for transfers of property and leasehold interests in transactions in which gain or loss is not recognized in whole or in part. Examples of these transactions would include transfers between a partnership and one or more of its partners, transfers to a controlled corporation under section 351, transfers pursuant to a reorganization described in section 368(a), like-kind exchanges subject to section 1031, and transfers by gift or upon the death of the owner of the property or the holder of the leasehold interest. The IRS and Treasury Department invite comments on whether special rules should be provided for any of these transactions.

8. *Proposed effective date*

The regulations are proposed to be effective for (1) rental agreements entered into after the date that final regulations under section 467 are published and (2) disqualified leasebacks and long-term agreements entered into after June 3, 1996. No inference should be drawn from the proposed effective date concerning the treatment of rental agreements entered into before the regulations are applicable. Moreover, the IRS will, in appropriate circumstances, apply the provisions of section 467 requiring constant rental accrual to rental agreements entered into on or before June 3, 1996.

9. *Issues not addressed*

The proposed regulations do not address the application of section 467 to payments for services. The IRS and the Treasury Department invite comments on the appropriate scope of rules under section 467 for transactions involving deferred payments for services in light of the scope of section 404. In addition, the IRS and the Treasury Department invite comments on whether rules should be provided for transactions involving prepayments for services.

The proposed regulations do not address the application of section 467 to transactions sometimes referred to as ''lease strips'' or ''stripping transactions'', as described in Notice 95–53 (1995–44 I.R.B. 21). Notice 95–53 provides that regulations will be issued pursuant to section 7701(*l*) (and, as appropriate, other sections of the Code) recharacterizing stripping transactions. The IRS and the Treasury Department invite comments on whether rules should be provided that would apply section 467 to such transactions.

The proposed regulations do not provide for an adjustment to section 467 rent and interest where a section 467 rental agreement is modified. The IRS and the Treasury Department invite comments on the appropriate treatment of the lessor and lessee in these cases.

The proposed regulations do not provide rules addressing the treatment of payments by the lessor to induce a lessee to enter into a rental agreement.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these proposed regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 25, 1996 at 10 a.m. in the Commissioner's Conference Room, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and submit an outline of the topics to be discussed and the time to be devoted to each topic by September 3, 1996. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Forest Boone of

the Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.467–1 is also issued under 26 U.S.C. 467.

Section 1.467–2 is also issued under 26 U.S.C. 467.

Section 1.467–3 is also issued under 26 U.S.C. 467.

Section 1.467–4 is also issued under 26 U.S.C. 467.

Section 1.467–5 is also issued under 26 U.S.C. 467.

Section 1.467–6 is also issued under 26 U.S.C. 467.

Section 1.467–7 is also issued under 26 U.S.C. 467.

Section 1.467–8 is also issued under 26 U.S.C. 467.

* * *

Par. 2. In §1.61–8, the first sentence of paragraph (b) is revised to read as follows:

§1.61–8 Rents and royalties.

* * * * * *

(b) * * * Except as provided in section 467 and the regulations thereunder, gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. * * *

* * * * * *

Par. 3. In §1.451–1, paragraph (g) is added to read as follows:

§1.451–1 General rule for taxable year of inclusion.

* * * * * *

(g) *Timing of income from section 467 rental agreements*. For the timing of income with respect to section 467 rental agreements, see section 467 and the regulations thereunder.

Par. 4. Section 1.461–1 is amended by:

1. Adding a sentence at the end of paragraph (a)(1).

2. Adding paragraph (a)(2)(iii)(E).

The additions read as follows:

§1.461–1. General rule for taxable year of deduction.

(a) * * * (1) * * * See section 467 and the regulations thereunder for rules under which a liability arising out of the use of property pursuant to a section 467 rental agreement is taken into account.

(2) * * *

(iii) * * *

(E) Except as otherwise provided by regulations or other published guidance issued by the Commissioner, in the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is to be taken into account under section 467 and the regulations thereunder.

* * * * * *

Par. 5. Section 1.461–4 is amended by:

1. Revising the heading of paragraph (d)(3)(ii).

2. Redesignating the text of paragraph (d)(3)(ii) following the heading as paragraph (d)(3)(ii)(A) and adding a heading for newly designated paragraph (d)(3)(ii)(A).

2. Adding paragraph (d)(3)(ii)(B).

3. Adding sentence at the end of the introductory text of paragraph (d)(7).

The revisions and additions read as follows:

§1.461–4 Economic performance.

* * * * * *

(d) * * *

(3) * * *

(ii) *Exceptions*—(A) *Volume, frequency of use, or income.* * * *

(B) *Section 467 rental agreements.* In the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, economic performance occurs as provided in §1.461–1(a)(2)(iii)(E).

* * * * * *

(7) * * * Assume further that the examples do not involve section 467 rental agreements and, therefore, section 467 is not applicable.

* * * * * *

Par. 6. Sections 1.467–0 through 1.467–8 are added to read as follows:

§1.467–0 Table of contents.

This section lists the major captions that appear in §§1.467–1 through 1.467–8.

§1.467–1 Treatment of lessors and lessees generally.

(a) Overview.
- (1) In general.
- (2) Cases in which rules are inapplicable.
- (3) Limited effect for rental agreements with total rents between $250,000 and $2,000,000.
- (4) Summary of rules.
  - (i) Basic rules.
  - (ii) Special rules.

(b) Method of accounting for section 467 rental agreements.

(c) Section 467 rental agreements.
- (1) In general.
- (2) Increasing or decreasing rent.
  - (i) Fixed rent.
    - (A) In general.
    - (B) Certain rent holidays disregarded.
  - (ii) Fixed rent allocated to a rental period.
    - (A) Specific allocation.
      - (*1*) In general.
      - (*2*) Rental agreements specifically allocating fixed rent.
    - (B) No specific allocation.
  - (iii) Contingent rent.
    - (A) In general.
    - (B) Certain contingent rent disregarded.
- (3) Deferred or prepaid rent.
  - (i) Deferred rent.
  - (ii) Prepaid rent.
  - (iii) Rent allocated to a calendar year.

- (iv) Examples.
  - (4) Rental agreements involving total payments of $250,000 or less.
    - (i) In general.
    - (ii) Special rules in computing amount described in paragraph (c)(4)(i).
- (d) Section 467 rent.
  - (1) In general.
  - (2) Fixed rent for a rental period.
    - (i) Constant rental accrual.
    - (ii) Proportional rental accrual.
    - (iii) Section 467 rental agreement accrual.
- (e) Section 467 interest.
  - (1) In general.
  - (2) Interest on fixed rent for a rental period.
    - (i) In general.
    - (ii) Section 467 rental agreements with adequate interest.
  - (3) Treatment of interest.
- (f) Modification of a rental agreement.
- (g) Treatment of amounts payable by essor to lessee.
  - (1) Interest.
  - (2) Other amounts. [Reserved]
- (h) Meaning of terms.
- (i) [Reserved]
- (j) Computational rules.
  - (1) Counting conventions.
  - (2) Conventions regarding timing of rent and payments.
    - (i) In general.
    - (ii) Time amount is payable.
  - (3) Annualized fixed rent.
  - (4) Allocation of fixed rent within a period.
  - (5) Rental period length.

§1.467–2 Rent accrual for section 467 rental agreements without adequate interest.

- (a) Section 467 rental agreement for which proportional rental accrual is required.
- (b) Adequate interest on fixed rent.
  - (1) In general.
  - (2) Section 467 rental agreements that provide for a variable rate of interest.
- (c) Computation of proportional rental amount.
  - (1) In general.
  - (2) Section 467 rental agreements that provide for a variable rate of interest.
- (d) Present value.
- (e) Applicable Federal rate.
  - (1) In general.
  - (2) Source of applicable Federal rates.
  - (3) 110 percent of applicable Federal rate.
  - (4) Term of the section 467 rental agreement.
    - (i) In general.
    - (ii) Section 467 rental agreements with variable interest.
- (f) Examples.

§1.467–3 Disqualified leasebacks and long-term agreements.

- (a) General rule.
- (b) Disqualified leaseback or long-term agreement.
  - (1) In general.
  - (2) Leaseback.
  - (3) Long-term agreement.
    - (i) In general.
    - (ii) Statutory recovery period.
      - (A) In general.
      - (B) Special rule for leases of properties having different statutory recovery periods.
- (c) Tax avoidance as principal purpose for increasing or decreasing rent.
  - (1) In general.
  - (2) Safe harbors.
- (d) Calculating constant rental amount.
  - (1) In general.
  - (2) Initial or final short periods.
  - (3) Method to determine constant rental amount; no short periods.
    - (i) Step 1.
    - (ii) Step 2.
    - (iii) Step 3.
- (e) Example.

§1.467–4 Section 467 loan.

- (a) In general.
  - (1) Overview.
  - (2) No section 467 loan in the case of certain section 467 rental agreements.
  - (3) Rental agreements subject to constant rental accrual.
  - (4) Special rule in applying the provisions of §1.467–7(e) or §1.467–7(f).
- (b) Principal balance.
  - (1) In general.
  - (2) Section 467 rental agreements that provide for prepaid fixed rent and adequate stated interest.
  - (3) Timing of payments.
- (c) Yield.
  - (1) In general.
    - (i) Method of determining yield.
    - (ii) Method of stating yield.
    - (iii) Rounding adjustments.
  - (2) Yield of section 467 rental agreements for which constant rental amount or proportional rental amount is computed.
  - (3) Determination of present values.
- (d) Contingent payments.
- (e) Section 467 rental agreements that call for payments before or after the lease term.
- (f) Examples.

§1.467–5 Section 467 rental agreements with variable interest.

- (a) Variable interest on deferred or prepaid rent.
  - (1) In general.
  - (2) Exceptions.
- (b) Variable rate treated as fixed.
  - (1) In general.
  - (2) Variable interest adjustment amount.
    - (i) In general.
    - (ii) Sign of adjustment.
  - (3) Section 467 loan balance.
- (c) Examples.

§1.467–6 Section 467 rental agreements with contingent payments. [Reserved]

§1.467–7 Section 467 recapture and other rules relating to dispositions.

- (a) Section 467 recapture.
- (b) Recapture amount.
  - (1) In general.
  - (2) Prior understated inclusions.
    - (i) In general.
    - (ii) Partial rental periods.
  - (3) Section 467 gain.
    - (i) In general.
    - (ii) Certain dispositions.
- (c) Special rules.
  - (1) Gifts.
  - (2) Dispositions at death.
  - (3) Certain tax-free exchanges.
    - (i) In general.
    - (ii) Dispositions covered.

(4) Dispositions by transferee.
(5) Like-kind exchanges and involuntary conversions.
(6) Installment sales.
(7) Dispositions covered by sections 170(e), 341(e)(12), or 751(c).
(d) Examples.
(e) Other rules relating to dispositions.
(1) In general.
(2) Treatment of section 467 loan.
(3) Special rules for transfers in certain nonrecognition transactions. [Reserved]
(f) Treatment of assignments by lessee and lessee-financed renewals.
(1) Substitute lessee use.
(2) Lessor use.
(3) Special rules for transfers in certain nonrecognition transactions. [Reserved]

§1.467–8 Effective date.

§1.467–1 Treatment of lessors and lessees generally.

(a) *Overview*—(1) *In general.* When applicable, section 467 requires a lessor and lessee of tangible property to treat rents consistently and to use the accrual method of accounting regardless of their overall method of accounting. In addition, in certain cases involving tax avoidance, the lessor and lessee must take rent and stated or imputed interest into account under a constant rental method, pursuant to which time value of money principles are applied to treat the rent as having accrued ratably over the entire lease term.

(2) *Cases in which rules are inapplicable.* Section 467 applies only to leases (or other similar arrangements) that constitute section 467 rental agreements as defined in paragraph (c) of this section. For example, a rental agreement is not a section 467 rental agreement, and, therefore, is not subject to the provisions of this section and §§1.467–2 through 1.467–8 (the section 467 regulations), if it specifies equal amounts of rent for each month (or other similar period) throughout the lease term and all payments of rent are due in the year to which the rent relates (or in the preceding or succeeding year). In addition, the section 467 regulations do not apply to a rental agreement that requires total rents of $250,000 or less determined, for this purpose, by disregarding any adjustments based on a reasonable price index and the amount of any rent resulting from the lessee's obligation to pay certain third-party expenses of the lessor.

(3) *Limited effect for rental agreements with total rents between $250,000 and $2,000,000.* A rental agreement is a section 467 rental agreement, and, therefore, the section 467 regulations generally apply, if the agreement requires total rents of more than $250,000 and does not specify equal amounts of rent for each month (or other similar period) throughout the lease term. If, however, the rental agreement requires total rents of $2,000,000 or less (determined by disregarding adjustments and excluding the same types of rent that are disregarded or excluded for purposes of the $250,000 threshold requirement) and all payments of rent are due in the year to which the rent relates (or in the preceding or succeeding year), the only effect of the section 467 regulations is to require the lessor and lessee to take rent into account in the year to which the rent relates.

(4) *Summary of rules*—(i) *Basic rules.* Paragraph (c) of this section provides rules for determining whether a rental agreement is a section 467 rental agreement. Paragraphs (d) and (e) of this section provide rules for determining the amount of rent and interest, respectively, required to be taken into account by a lessor and lessee under a section 467 rental agreement. Paragraphs (f) through (h) and (j) of this section provide various definitions and special rules relating to the application of the section 467 regulations.

(ii) *Special rules.* Section 1.467–2 provides rules for section 467 rental agreements that have deferred or prepaid rents without providing for adequate interest. Section 1.467–3 provides rules for application of the constant rental accrual requirement, including criteria for determining whether an agreement is subject to this requirement. Section 1.467–4 provides rules for establishing and adjusting a section 467 loan, , the amount that a lessor is deemed to have loaned to the lessee, or vice versa, pursuant to the application of the section 467 regulations. Sections 1.467–5 and 1.467–6 provide rules for applying the section 467 regulations where a rental agreement requires variable interest or certain contingent payments. Section 1.467–7 provides rules for the treatment of dispositions by a lessor of property subject to a section 467 rental agreement and the treatment of assignments by lessees and certain lessee-financed renewals of a section 467 rental agreement. Finally, §1.467–8 provides the effective date rules for the section 467 regulations.

(b) *Method of accounting for section 467 rental agreements.* If a rental agreement is a section 467 rental agreement, as described in paragraph (c) of this section, the lessor and lessee must each take into account for any taxable year—

(1) The section 467 rent for the taxable year (as defined in paragraph (d) of this section); and

(2) The section 467 interest for the taxable year (as defined in paragraph (e) of this section).

(c) *Section 467 rental agreements*—(1) *In general.* Except as otherwise provided in paragraph (c)(4) of this section, the term *section 467 rental agreement* means a rental agreement, as defined in paragraph (h) of this section, that has increasing or decreasing rents (as described in paragraph (c)(2) of this section), or prepaid or deferred rents (as described in paragraph (c)(3) of this section).

(2) *Increasing or decreasing rent*—(i) *Fixed rent*—(A) *In general.* A rental agreement has increasing or decreasing rent if the annualized fixed rent, as described in paragraph (j)(3) of this section, allocated to any rental period exceeds the annualized fixed rent allocated to any other rental period in the lease term.

(B) *Certain rent holidays disregarded.* Notwithstanding the provisions of paragraph (c)(2)(i)(A) of this section, a rental agreement does not have increasing or decreasing rent if the increasing or decreasing rent is solely attributable to a rent holiday provision allowing reduced rent (including no rent) for a period at the beginning of the lease term, but only if the duration of the rent holiday does not exceed three months.

(ii) *Fixed rent allocated to a rental period*—(A) *Specific allocation*—(*1*) *In general.* If a rental agreement provides a specific allocation of fixed rent, as described in paragraph (c)(2)(ii)(A)(*2*) of this section, the amount of fixed rent

allocated to each rental period during the lease term is the amount of fixed rent allocated to that period by the rental agreement.

(*2*) *Rental agreements specifically allocating fixed rent*. A rental agreement specifically allocates fixed rent if the rental agreement unambiguously specifies, for periods no longer than a year, a fixed amount of rent for which the lessee becomes liable on account of the use of the property during that period, and the total amount of fixed rent specified is equal to the total amount of fixed rent payable under the lease. For example, a rental agreement providing that rent is $100,000 per calendar year, and that provides for total payments of fixed rent equal to the total amount specified, specifically allocates rent. Similarly, a rental agreement that states the amount of rent accruing each month or the amount of rent allocated to each year contains a specific allocation if the total payments of fixed rent equal the total amount specified. A rental agreement stating only when rent is payable does not specifically allocate rent.

(B) *No specific allocation*. If a rental agreement does not provide a specific allocation of fixed rent (for example, because the total amount of fixed rent specified is not equal to the total amount of fixed rent payable under the lease), the amount of fixed rent allocated to a rental period is the amount of fixed rent payable during that rental period. If an amount of fixed rent is payable before the beginning of the lease term, it is allocated to the first rental period in the lease term. If an amount of fixed rent is payable after the end of the lease term, it is allocated to the last rental period in the lease term.

(iii) *Contingent rent*—(A) *In general*. A rental agreement has increasing or decreasing rent if it requires (or may require) the payment of contingent rent (as defined in paragraph (h) of this section), other than contingent rent described in paragraph (c)(2)(iii)(B) of this section.

(B) *Certain contingent rent disregarded*. Contingent rent is disregarded for purposes of this paragraph (c)(2)(iii) to the extent—

(*1*) The rent is contingent solely as the result of a provision pursuant to which the rent is equal to a percentage of the lessee's receipts (gross or net), but only if the percentage does not vary throughout the term of the lease;

(*2*) The rent is contingent solely as the result of an adjustment based on a reasonable price index, as defined in paragraph (h) of this section; or

(*3*) The rent is contingent solely as the result of a provision requiring the lessee to pay third-party costs, as defined in paragraph (h) of this section.

(3) *Deferred or prepaid rent*—(i) *Deferred rent*. A rental agreement has deferred rent under this paragraph (c)(3) if the amount of rent allocated to a calendar year (determined under paragraph (c)(3)(iii) of this section), when added to the rent allocated to all preceding calendar years, exceeds the cumulative amount of rent payable as of the close of the succeeding calendar year.

(ii) *Prepaid rent*. A rental agreement has prepaid rent under this paragraph (c)(3) if the amount of rent allocated to a calendar year (determined under paragraph (c)(3)(iii) of this section), when added to the rent allocated to all preceding calendar years, is less than the cumulative amount of rent payable before the beginning of the preceding calendar year.

(iii) *Rent allocated to a calendar year*. For purposes of this paragraph (c)(3), the rent allocated to a calendar year is the sum of—

(A) The fixed rent allocated to any rental period (determined under paragraph (c)(2)(ii) of this section) that begins and ends in the calendar year;

(B) A ratable portion of the fixed rent allocated to any other rental period that begins or ends in the calendar year; and (C) Any contingent rent that accrues during the calendar year as provided in §1.467–6.

(iv) *Examples*. The following examples illustrate the application of this paragraph (c)(3):

Example 1. (i) A and B enter into a rental agreement that provides for the lease of property to begin on January 1, 1997, and end on December 31, 2000. The rental agreement provides that rent of $100,000 accrues during each year of the lease term. Under the rental agreement, no rent is payable during calendar year 1997, a payment of $100,000 is to be made on December 31, 1998, and December 31, 1999, and a payment of $200,000 is to be made on December 31, 2000. A and B both select the calendar year as their rental period. Thus, under paragraph (c)(3)(iii) of this section, the amount of rent allocated to each rental period under paragraph (c)(2)(ii) of this section is $100,000. Therefore, the rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section.

(ii) Under paragraph (c)(3)(i) of this section, a rental agreement has deferred rent if, at the close of a calendar year, the cumulative amount of rent allocated under paragraph (c)(3)(iii) of this section exceeds the cumulative amount of rent payable as of the close of the succeeding year. In this example, there is no deferred rent: the rent allocated to 1997 ($100,000) does not exceed the cumulative rent payable as of December 31, 1998 ($100,000); the rent allocated to 1998 and preceding years ($200,000) does not exceed the cumulative rent payable as of December 31, 1999 ($200,000); the rent allocated to 1999 and preceding years ($300,000) does not exceed the cumulative rent payable as of December 31, 2000 ($400,000); and the rent allocated to 2000 and preceding years ($400,000) does not exceed the cumulative rent payable as of December 31, 2001 ($400,000). Therefore, because the rental agreement does not have increasing or decreasing rent and does not have prepaid or deferred rent, the rental agreement is not a section 467 rental agreement.

Example 2. (i) A and B enter into a rental agreement that provides for the lease of personal property for ten years, beginning on January 1, 1997, and ending on December 31, 2006. The rental agreement provides for accruals of rent of $10,000 during each month of the lease term. Under paragraph (c)(3)(iii) of this section, $120,000 is allocated to each calendar year. The rental agreement provides for a $1,200,000 payment on December 31, 1997.

(ii) The rental agreement does not have increasing or decreasing rent as described in paragraph (c)(2)(i) of this section. The rental agreement provides prepaid rent under paragraph (c)(3)(ii) of this section because an amount of rent allocated to a calendar year, when added to the rent allocated to all preceding calendar years, is less than the cumulative amount of rent payable before the beginning of the preceding calendar year. For example, the rent allocated to 1999 and preceding calendar years ($360,000) is less than the cumulative amount of rent payable before the beginning of the preceding calendar year ($1,200,000 is payable on December 31, 1997). Accordingly, the rental agreement is a section 467 rental agreement.

(4) *Rental agreements involving total payments of $250,000 or less*—(i) *In general*. A rental agreement is not a section 467 rental agreement if, taking into account any payments of contingent rent, and any other contingent consideration, the sum of the aggregate amount of rental payments under the rental agreement and the aggregate value of other consideration to be received for the use of property is not reasonably expected, as of the agreement date (as defined in paragraph (h) of this section), to exceed $250,000.

(ii) *Special rules in computing amount described in paragraph (c)(4)(i)*. The following rules apply in determining the amount described in paragraph (c)(4)(i) of this section—

(A) Stated interest on deferred rent is not taken into account. However, the Commissioner may recharacterize a

portion of stated interest as additional rent if a rental agreement provides for interest on deferred rent at a rate that, in light of all of the facts and circumstances, is clearly greater than the arm's-length rate of interest that would have been charged in a lending transaction between the lessor and lessee.

(B) Consideration that does not involve a cash payment is taken into account at its fair market value. A liability that is either assumed or secured by property acquired subject to the liability is taken into account at its remaining principal amount or, in the case of an obligation originally issued at a discount, at its adjusted issue price.

(C) All leases that are part of the same transaction or a series of related transactions are treated as a single lease. Whether two or more leases are part of the same transaction or a series of related transactions depends on all the facts and circumstances.

(D) Any increase or decrease in rent payable solely as a result of an adjustment based on a reasonable price index is not taken into account.

(E) Contingent rent described in paragraph (c)(2)(iii)(B)(*3*) of this section is not taken into account.

(d) *Section 467 rent*—(1) *In general*. The section 467 rent for a taxable year is the sum of—

(i) The fixed rent for any rental period (determined under paragraph (d)(2) of this section) that begins and ends in the taxable year;

(ii) A ratable portion of the fixed rent for any other rental period beginning or ending in the taxable year; and

(iii) In the case of a section 467 rental agreement that provides for contingent rent, the contingent rent that accrues during the taxable year as provided in §1.467–6.

(2) *Fixed rent for a rental period*—(i) *Constant rental accrual*. In the case of a section 467 rental agreement that is a disqualified leaseback or long-term agreement (as described in §1.467–3(b)), the fixed rent for a rental period is the constant rental amount (as determined under §1.467–3(d)).

(ii) *Proportional rental accrual*. In the case of a section 467 rental agreement that is not described in paragraph (d)(2)(i) of this section, and does not provide adequate interest on fixed rent (as determined under §1.467–2(b)), the fixed rent for a rental period is the proportional rental amount (as determined under §1.467–2(c)).

(iii) *Section 467 rental agreement accrual*. In the case of a section 467 rental agreement that is not described in paragraph (d)(2)(i) or (ii) of this section, the fixed rent for a rental period is the amount of fixed rent allocated to the rental period under the rental agreement, as determined under paragraph (c)(2)(ii) of this section.

(e) *Section 467 interest*—(1) *In general*. The section 467 interest for a taxable year is the sum of—

(i) The interest on fixed rent for any rental period that begins and ends in the taxable year;

(ii) A ratable portion of the interest on fixed rent for any other rental period beginning or ending in the taxable year; and

(iii) In the case of a section 467 rental agreement that provides for contingent rent, any interest that accrues on the contingent rent during the taxable year as provided in §1.467–6.

(2) *Interest on fixed rent for a rental period*—(i) *In general*. Except as provided in paragraph (e)(2)(ii) of this section and §1.467–5(b)(1)(ii), the interest on fixed rent for a rental period is equal to the product of—

(A) The principal balance of the section 467 loan (as described in §1.467–4(b)) at the beginning of the rental period; and

(B) The yield of the section 467 loan (as described in §1.467–4(c)).

(ii) *Section 467 rental agreements with adequate interest*. Except in the case of a section 467 rental agreement that is a disqualified leaseback or long-term agreement, if a section 467 rental agreement provides adequate interest under §1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467–2(b)(1)(ii) (agreements with adequate stated interest at a single fixed rate), the interest on fixed rent for a rental period is the amount of interest provided in the rental agreement for the period.

(3) *Treatment of interest*. If the section 467 interest for a rental period is a positive amount, the lessor has interest income and the lessee has an interest expense. If the section 467 interest for a rental period is a negative amount, the lessee has interest income and the lessor has an interest expense.

(f) *Modification of a rental agreement*. If, after the lease date, the lessor and lessee agree to a substantial modification of the terms of a lease, the modified lease is treated, except as provided in this paragraph (f), as a new rental agreement for purposes of this section and §§1.467–2 through 1.467–8. If a principal purpose of such a modification is to avoid the purpose or intent of section 467, the Commissioner may treat the original and modified lease as a single rental agreement for purposes of this section and §§1.467–2 through 1.467–8.

(g) *Treatment of amounts payable by lessor to lessee*—(1) *Interest*. For purposes of determining present value, any amounts payable by the lessor to the lessee as interest on prepaid rent are treated as negative amounts.

(2) *Other amounts*. [Reserved]

(h) *Meaning of terms*. The following meanings apply for purposes of this section and §§1.467–2 through 1.467–8—

(1) *Agreement date* means the earlier of the lease date or the first date on which there is a binding written contract that substantially sets forth the terms under which the property will be leased.

(2) *Contingent rent* means any rent that is not fixed rent, including any amount reflecting an adjustment based on a reasonable price index.

(3) *Fixed rent* means any rent to the extent its amount and the time at which it will be paid are fixed and determinable under the terms of the section 467 rental agreement as of the lease date, as defined in paragraph (h)(4) of this section. For this purpose, the possibility of a breach or other early termination of the rental agreement and any provision that makes adjustments based on a reasonable price index are disregarded in determining whether amounts specified in the agreement are fixed rent.

(4) *Lease date* means the date on which the lessee first has the right to use property that is the subject of the section 467 rental agreement.

(5) *Lease term* means the period during which the lessee has the use of property subject to the section 467 rental agreement. An option period is included in the lease term only if it is expected, as of the agreement date, that the option will be exercised by either the lessor or the lessee. For this purpose, a lessor is generally expected to exercise an option if, for example, as of the agreement date, the rent in effect

for the option period exceeds the expected market rental for the property during such period. Similarly, a lessee is generally expected to exercise an option if, for example, as of the agreement date, the rent for the option period is less than the expected market rental for such period. The lessor's or lessee's determination that an option period is either included in or excluded from the lease term is not binding on the Commissioner. If the lessee (or a related person) agrees that one or both of them will or could be obligated to make payments in the nature of rent (within the meaning of §1.168(i)–2(b)(2)) for a period when another lessee (the substitute lessee) or the lessor will have use of the property subject to the rental agreement, the Commissioner may, in appropriate cases, treat the period when the substitute lessee or lessor will have use of the property as part of the lease term. See paragraph §1.467–7(f) for special rules applicable to the lessee, substitute lessee, and lessor.

(6) An adjustment is *based on a reasonable price index* if the adjustment reflects inflation or deflation occurring over a period during the lease term and is determined consistently under any generally recognized index for measuring inflation or deflation.

(7) Except as otherwise provided in this paragraph (h)(7), two persons are *related persons* if they either have a relationship to each other that is specified in section 267(b) or section 707(b)(1) or are related entities within the meaning of sections 168(h)(4)(A), (B), or (C). For purposes of determining whether a section 467 rental agreement is a leaseback within the meaning of §1.467–3(b)(2), two persons are *related persons* if they are related persons within the meaning of section 465(b)(3)(C).

(8) *Rental agreement* includes any agreement, whether written or oral, that provides for the use of tangible property and is treated as a lease for Federal income tax purposes.

(9) *Third-party costs* include any real estate taxes, insurance premiums, maintenance costs, or any other cost (other than a debt service cost) that relates to the leased property and is not within the control of the lessor or lessee or any related person.

(i) [Reserved].

(j) *Computational rules*. For purposes of this section and §§1.467–2 through 1.467–8, the following rules apply—

(1) *Counting conventions*. Any reasonable counting convention may be used (*e.g.,* 30 days per month/360 days per year) to determine the length of a rental period or to perform any computation. Rental periods of the same descriptive length, for example annual, semiannual, quarterly, or monthly, may be treated as being of equal length.

(2) *Conventions regarding timing of rent and payments*—(i) *In general*. For purposes of determining present values and yield—

(A) Except as otherwise provided in this section and §§1.467–2 through 1.467–7, the rent allocated to a rental period is taken into account on the last day of the rental period;

(B) Any amount payable during the first half of the first rental period is treated as payable on the first day of that rental period;

(C) Any amount payable during the first half of any other rental period is treated as payable on the last day of the preceding rental period; and

(D) Any amount payable during the second half of a rental period is treated as payable on the last day of the rental period.

(ii) *Time amount is payable*. For purposes of this paragraph (j)(2), an amount is payable on the last day for timely payment (that is, the last day such amount may be paid without incurring interest, computed at an arm's-length rate, or a substantial penalty charge) and an amount payable at the midpoint of a rental period is treated as payable during the first half of the rental period.

(3) *Annualized fixed rent*. Annualized fixed rent is determined by multiplying the fixed rent allocated to the rental period under paragraph (c)(2)(ii) of this section by a number that represents the ratio of one year to the length of the rental period. Thus, if the fixed rent allocated to a rental period is $100,000 and the rental period is one month, the annualized fixed rent allocated to the rental period is $1,200,000.

(4) *Allocation of fixed rent within a period*. A rental agreement that allocates fixed rent to any period is treated as allocating fixed rent ratably within that period. Thus, if a rental agreement provides that $120,000 is allocated to each calendar year in the lease term, $10,000 of rent is allocated to each calendar month.

(5) *Rental period length*. Except as provided in §1.467–3(d)(1) (relating to agreements for which constant rental accrual is required), rental periods may be of any length and may vary in length as long as—

(i) The rental periods are one year or less, cover the entire lease term, and do not overlap;

(ii) Each scheduled payment under the rental agreement (other than a payment scheduled to occur before or after the lease term) occurs within 30 days of the beginning or end of a rental period; and

(iii) In the case of a rental agreement that does not provide a specific allocation of fixed rent, the rental periods selected do not cause the agreement to be treated as a section 467 rental agreement unless all alternative rental period schedules would result in such treatment.

§1.467–2 Rent accrual for section 467 rental agreements without adequate interest.

(a) *Section 467 rental agreement for which proportional rental accrual is required*. Under §1.467–1(d)(2)(ii), the fixed rent for each rental period is the proportional rental amount, defined under paragraph (c) of this section, if—

(1) The section 467 rental agreement is not a disqualified leaseback or long-term agreement under §1.467–3(b); and

(2) The section 467 rental agreement does not provide adequate interest on fixed rent under paragraph (b) of this section.

(b) *Adequate interest on fixed rent*—(1) *In general*. A section 467 rental agreement provides adequate interest on fixed rent if, disregarding any contingent rent—

(i) The rental agreement has no prepaid or deferred rent as described in §1.467-1(c)(3);

(ii) The rental agreement has prepaid or deferred rent, and—

(A) The rental agreement provides interest (the stated rate of interest) on deferred or prepaid fixed rent at a single fixed rate (as defined in §1.1273-1(c)(1)(iii));

(B) The stated rate of interest on fixed rent is no lower than 110 percent of the applicable Federal rate (as

defined in paragraph (e)(3) of this section);

(C) The amount of deferred or prepaid fixed rent on which interest is charged is adjusted at least annually to reflect the amount of deferred or prepaid fixed rent as of a date no earlier than the date of the preceding adjustment and no later than the date of the succeeding adjustment; and

(D) The rental agreement requires interest to be paid or compounded at least annually;

(iii) The rental agreement provides for deferred rent but no prepaid rent, and the sum of the present values of all amounts payable by the lessee as fixed rent (and interest, if any, thereon) is equal to or greater than the sum of the present values of the fixed rent allocated to each rental period; or

(iv) The rental agreement provides for prepaid rent but no deferred rent, and the sum of the present values of all amounts payable by the lessee as fixed rent, plus the sum of the negative present values of all amounts payable by the lessor as interest, if any, on prepaid fixed rent, is equal to or less than the sum of the present values of the fixed rent allocated to each rental period.

(2) *Section 467 rental agreements that provide for a variable rate of interest*. For purposes of the adequate interest test under paragraph (b)(1) of this section, if a section 467 rental agreement provides for variable interest, the rental agreement is treated as providing for fixed rates of interest on deferred or prepaid fixed rent equal to the fixed rate substitutes (determined in the same manner as under §1.1275–5(e) treating the agreement date as the issue date) for the variable rates called for by the rental agreement. For purposes of this section, a rental agreement provides for variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275–5(a)(3)(i)(A) or (B) and §1.1275–5(a)(4).

(c) *Computation of proportional rental amount*—(1) *In general*. The proportional rental amount for a rental period is the amount of fixed rent allocated to the rental period under §1.467–1(c)(2)(ii), multiplied by a fraction. The numerator of the fraction is the sum of the present values of the amounts payable under the terms of the section 467 rental agreement as fixed rent and interest thereon. The denominator of the fraction is the sum of the present values of the fixed rent allocated to each rental period under the rental agreement.

(2) *Section 467 rental agreements that provide for a variable rate of interest*. To calculate the proportional rental amount for a section 467 rental agreement that provides for a variable rate of interest, see §1.467–5.

(d) *Present value*. For purposes of determining adequate interest under paragraph (b) of this section or the proportional rental amount under paragraph (c) of this section, present values are determined as of the first day a fixed rent payment is called for by the section 467 rental agreement if the rental agreement calls for payments of fixed rent prior to the lease term. Otherwise, present values are determined as of the first day of the first rental period in the lease term. The present value of any amount is determined using a discount rate equal to 110 percent of the applicable Federal rate. For purposes of the present value determination under paragraph (b)(1)-(iv) of this section, the fixed rent allocated to a rental period must be discounted from the first day of the rental period. For other conventions and rules relating to the determination of present value, see §1.467–1(g) and (j).

(e) *Applicable Federal rate*—(1) *In general*. The applicable Federal rate for a section 467 rental agreement is the applicable Federal rate in effect on the agreement date. Except as otherwise provided in this section, the *applicable Federal rate* for a rental agreement means—

(i) The Federal short-term rate if the term of the rental agreement is not over 3 years;

(ii) The Federal mid-term rate if the term of the rental agreement is over 3 years but not over 9 years; and

(iii) The Federal long-term rate if the term of the rental agreement is over 9 years.

(2) *Source of applicable Federal rates*. The Internal Revenue Service publishes the applicable Federal rates, based on annual, semiannual, quarterly, and monthly compounding, each month in the Internal Revenue Bulletin (see §601.601(d) of this chapter. However, the applicable Federal rates may be based on any compounding assumption. To convert a rate based on one compounding assumption to an equivalent rate based on a different compounding assumption, see §1.1272–1(j), *Example 1*.

(3) *110 percent of applicable Federal rate*. For purposes of §1.467–1, this section and §§1.467–3 through 1.467–8, 110 percent of the applicable Federal rate means 110 percent of the applicable Federal rate based on semiannual compounding, or any rate based on a different compounding assumption that is equivalent to 110 percent of the applicable Federal rate based on semiannual compounding.

(4) *Term of the section 467 rental agreement*—(i) *In general*. For purposes of determining 110 percent of the applicable Federal rate under this paragraph (e), the term of the section 467 rental agreement includes the lease term, any period before the lease term beginning with the first day an amount of fixed rent is payable under the terms of the rental agreement, and any period after the lease term ending with the last day an amount of fixed rent or interest thereon is payable under the rental agreement.

(ii) *Section 467 rental agreements with variable interest*. If a section 467 rental agreement provides variable interest on prepaid or deferred fixed rent, the term of the rental agreement for purposes of calculating 110 percent of the applicable Federal rate is determined in accordance with paragraph (e)(4)(i) of this section by substituting for the term of the rental agreement, the longest period between interest rate adjustment dates, or, if the rental agreement provides an initial fixed rate of interest on prepaid or deferred fixed rent, the period between the agreement date and the last day the fixed rate applies, if this period is longer. If, as described in §1.1274–4(c)(2)(ii), the rental agreement provides for a qualified floating rate (as defined in §1.1275–5(b)) that in substance resembles a fixed rate, 110 percent of the applicable Federal rate is determined by reference to the lease term.

(f) *Examples*. The following examples illustrate the application of this section. In each of these examples it is assumed that constant rental accrual does not apply:

Example 1. (i) C agrees to lease property from D for five years beginning on January 1, 1998, and ending on December 31, 2002. The section

467 rental agreement provides that rent of $100,000 accrues in each calendar year in the lease term and that rent of $500,000 plus $120,000 of interest is payable on December 31, 2002. Assume that the parties select the calendar year as the rental period and that 110 percent of the applicable Federal rate based on annual compounding is 10 percent.

(ii) The rental agreement has deferred rent under §1.467–1(c)(3)(i) because the fixed rent allocated to calendar years 1998, 1999, and 2000 is not paid until 2002. In addition, because the rental agreement does not state an interest rate, the rental agreement does not satisfy the requirements of paragraph (b)(1)(ii) of this section. Thus, the adequacy of interest must be determined under paragraph (b)(1)(iii) of this section.

(iii)(A) Because the rental agreement has deferred fixed rent and no prepaid rent, the agreement has adequate interest only if the present value rules provided in paragraph (b)(1)(iii) are met. The present value of all fixed rent and interest payable under the rental agreement is $384,971.22, determined as follows: $\$384,971.22 = \$620,000/(1.10)^5$. The present value of all fixed rent allocated under the rental agreement (discounting the amount of fixed rent allocated to a rental period from the last day of the rental period) is $379,078.68, determined as follows:

$$\$379,078.78 = \$1000,000 \times \frac{1-(1.10)^5}{.10}$$

(B) Accordingly, the sum of the present values of amounts payable exceeds the sum of the present values of fixed rent allocated. The rental agreement provides adequate interest on fixed rent.

(iv) For an example illustrating the computation of the yield on the rental agreement and the allocation of the interest and rent provided for under the rental agreement, see §1.467–4(f), *Example 2*.

Example 2. (i) E and F enter into a section 467 rental agreement for the lease of equipment beginning on January 1, 1998, and ending on December 31, 2002. The rental agreement provides that rent of $100,000 accrues for each calendar month during the lease term. All rent is payable on December 31, 2002, together with interest on accrued rent at a qualified floating rate set at a current value (as defined in §1.1275–5(a)(4)) that is compounded at the end of each calendar month and adjusted at the beginning of each calendar month throughout the lease term. Therefore, the rental agreement provides for variable interest within the meaning of paragraph (b)(2) of this section.

(ii) On the agreement date the qualified floating rate is 7.5 percent, and 110 percent of the applicable Federal rate, as defined in paragraph (e)(3) of this section, based on monthly compounding, is 7 percent. Under paragraph (b)(2) of this section, the fixed rate substitute for the qualified floating rate is 7.5 percent and the agreement is treated as providing for interest at this fixed rate for purposes of determining whether adequate interest is provided under paragraph (b) of this section. Accordingly, the requirements of paragraph (b)(1)(ii) of this section are satisfied, and the rental agreement has adequate interest.

Example 3. (i) X and Y enter into a section 467 rental agreement for the lease of real property beginning on January 1, 1998, and ending on December 31, 2000. The rental agreement provides that rent of $80,000 is allocable to 1998, $100,000 is allocable to 1999, and $120,000 is allocable to 2000. Under the rental agreement, Y must make a $300,000 payment on December 31, 2000. Assume that both X and Y choose the calendar year as the rental period, X and Y are calendar year taxpayers, and 110 percent of the applicable Federal rate is 8.5 percent compounded annually. Assume further that the rental agreement fails to provide adequate interest under paragraph (b)(1) of this section. Therefore, under §1.467–1(d)-(2)(ii), the fixed rent for each rental period is the proportional rental amount.

(ii)(A) The proportional rental amount is computed under paragraph (c) of this section. Because the rental agreement does not call for any fixed rent payments prior to the lease term, under paragraph (d) of this section, present value is determined as of the first day of the first rental period in the lease term. The sum of the present values of the amounts payable by the lessee under the rental agreement is computed as follows:

$$\$234,872.43 = \frac{\$300,000}{(1 + .085)^3}$$

(B) The sum of the present values of the fixed rent allocated to each rental period (discounting the fixed rent allocated to a rental period from the last day of such rental period) is computed as follows:

$$\$252,627.22 = \frac{\$80,000}{(1+.085)} + \frac{\$100,000}{(1+.085)^2} + \frac{\$120,000}{(1+.085)^3}$$

(C) Thus, the fraction for determining the proportional rental amount is .9297194 ($234,872.43/$252,627.22). The section 467 fixed rents for the taxable years within the lease term are:

Taxable year	*Section 467 rent*
1998	$ 74,377.55 ($ 80,000 × .9297194)
1999	92,971.94 ($100,000 × .9297194)
2000	111,566.33 ($120,000 × .9297194)

§1.467–3 Disqualified leasebacks and long-term agreements.

(a) *General rule*. Under §1.467–1(d)(2)(i), constant rental accrual (as described under paragraph (d) of this section) must be used to determine the fixed rent for each rental period in the lease term if the section 467 rental agreement is a disqualified leaseback or long-term agreement within the meaning of paragraph (b) of this section.

(b) *Disqualified leaseback or long-term agreement*—(1) *In general*. A leaseback (as defined in paragraph (b)(2) of this section) or a long-term agreement (as defined in paragraph (b)(3) of this section) is disqualified only if—

(i) The amount determined with respect to the section 467 rental agreement under §1.467–1(c)(4) (relating to the exception for rental agreements involving total payments of $250,000 or less) exceeds $2,000,000;

(ii) A principal purpose for providing increasing or decreasing rent is the avoidance of Federal income tax (as described in paragraph (c) of this section); and

(iii) The Commissioner determines that it is appropriate to treat the section 467 rental agreement as a disqualified leaseback or long-term agreement.

(2) *Leaseback*. A section 467 rental agreement is a leaseback if the lessee (or a related person) had any interest (other than a de minimis interest) in the property at any time during the two-year period ending on the agreement date. For this purpose, interests in property include options and agreements to purchase the property (whether or not the lessee or related person was considered the owner of the property for Federal income tax purposes) and, in the case of subleased property, any interest as a sublessor.

(3) *Long-term agreement*—(i) *In general*. A section 467 rental agreement is a long-term agreement if the lease term exceeds 75 percent of the statutory recovery period for the property.

(ii) *Statutory recovery period*—(A) *In general*. The term *statutory recovery period* means—

(*1*) In the case of property depreciable under section 168, the applicable period determined under section 467(e)(3)(A);

(*2*) In the case of land, 19 years; and

(*3*) In the case of any other tangible property, the period that would apply under section 467(e)(3)(A) if the property were property to which section 168 applied.

(B) *Special rule for leases of properties having different statutory recovery periods*. In the case of a lease of two or more related properties that have different statutory recovery periods, the statutory recovery period for purposes of paragraph (b)(3)(ii)(A) of this section is the weighted average, based on the fair market values of the properties on the lease date, of the statutory recovery periods of each of the properties.

(c) *Tax avoidance as principal purpose for increasing or decreasing*

rent—(1) *In general*. Whether tax avoidance is a principal purpose for providing increasing or decreasing rent in a leaseback or long-term agreement is based on all of the facts and circumstances. However, if either the lessee or the lessor is not subject to Federal income tax on its income or is a tax-exempt entity (within the meaning of section 168(h)(2)), the agreement will be closely scrutinized and clear and convincing evidence will be required to establish that tax avoidance is not a principal purpose for providing increasing or decreasing rent.

(2) *Safe harbors*. Tax avoidance is not considered to be a principal purpose for providing increasing or decreasing rent if—

(i) The rent allocated to each calendar year (determined without regard to any increase or decrease attributable to a provision described in paragraph (c)(2)(ii)(C) of this section) does not vary from the average rent allocated to all calendar years by more than 10 percent (for this purpose, the rent allocated to a partial calendar year is adjusted by multiplying the rent by the number of partial years in a full calendar year); or

(ii) All of the increases and decreases in rent are attributable to one or more of the following provisions—

(A) A provision requiring an increase in rent equal to a percentage of the lessee's receipts (gross or net) if the percentage does not vary throughout the term of the lease;

(B) A provision requiring an adjustment based on a reasonable price index as described in §1.467–1(h);

(C) A provision requiring the lessee to pay third-party costs as described in §1.467–1(h); or

(D) A rent holiday provision allowing reduced rent (including no rent) for an interim period at the beginning of the lease term, but only if the duration of the rent holiday does not exceed the lesser of 24 months or 10 percent of the lease term and there is a substantial business purpose for the rent holiday provision.

(d) *Calculating constant rental amount*—(1) *In general*. Except as provided in paragraph (d)(2) of this section, the constant rental amount is the amount that, if paid at the end of each rental period, would result in a present value equal to the present value of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. In computing the constant rental amount, the rules for determining present value are the same as those provided in §1.467–2(d) for computing the proportional rental amount. If constant rental accrual is required, all rental periods (other than an initial or final short period of not more than one month) must be equal in length and satisfy the requirements of §1.467–1(j)(5).

(2) *Initial or final short periods*. If a disqualified leaseback or long-term agreement has an initial or final short rental period, the constant rental amount for the initial or final short period may be determined under any reasonable method. However, the sum of the present values of all the constant rental amounts must equal the present values of all amounts payable under the disqualified leaseback or long-term agreement as rent and interest. Any adjustment necessary to eliminate the section 467 loan balance because of the method used to determine the constant rental amount for short periods must be taken into account as section 467 rent for the final rental period.

(3) *Method to determine constant rental amount; no short periods*—(i) *Step 1*. Determine the present value of amounts payable under the disqualified leaseback or long-term agreement as rent or interest.

(ii) *Step 2*. Determine the present value of $1 to be received at the end of each rental period during the lease term as of the first day of the first rental period during the lease term (or, if earlier, the first day a rent payment is required under the rental agreement).

(iii) *Step 3*. Divide the amount determined in paragraph (d)(3)(i) of this section (Step 1) by the number of dollars determined in paragraph (d)(3)(ii) of this section (Step 2).

(e) *Example*. The following example illustrates the application of paragraph (d) of this section:

Example. (i) X and Y enter into a disqualified leaseback for a 5-year lease of personal property beginning on January 1, 1998, and ending on December 31, 2002. The rental agreement provides that $0 of rent is allocated to years 1998, 1999, and 2000, and that rent of $17,500,000 is allocated to years 2001 and 2002. The rental agreement provides that the rent allocated to each year is payable on December 31 of that year. Assume all rental periods are the calendar year. Assume also that 110 percent of the applicable Federal rate based on annual compounding is 12 percent.

(ii) Step 1 in calculating the constant rental amount is to determine the present value of the two payments due under the rental agreement as follows:

$$\$21,051,536 = \frac{\$17,500,000}{(1.12)^4} + \frac{\$17,500,000}{(1.12)^5}$$

(iii) Because no amounts of rent are payable before the lease term, Step 2 in calculating the constant rental amount is to determine the present value as of the first day of the lease term of $1 to be received at the end of each rental period during the lease term. This results in a present value of $3.6047762. In Step 3 the amount determined in Step 1 is divided by the number of dollars determined in Step 2. Thus, the constant rental amount is $5,839,901 for each calendar year during the lease term computed as follows:

$$\$5,839,901 = \frac{\$21,051,536}{3.6047762}$$

§1.467–4 Section 467 loan.

(a) *In general*—(1) *Overview*. Except as provided in paragraph (a)(2) of this section, the section 467 loan rules of this section apply to a section 467 rental agreement if, as of the first day of that period, there is a difference between the amount of fixed rent payable under the rental agreement on or before the first day and the amount of fixed rent required to be accrued in accordance with §1.467–1(d)(2) before the first day. Paragraph (b) of this section provides rules for computing the principal balance of a section 467 loan at the beginning of any rental period. The principal balance of a section 467 loan may be positive or negative. For purposes of the Code, if the principal balance is positive, the amount represents a loan from the lessor to the lessee and, if the principal balance is negative, the amount represents a loan from the lessee to the lessor.

(2) *No section 467 loan in the case of certain section 467 rental agreements*. Except as provided in paragraph (a)(3) and (4) of this section, this section does not apply to section 467 rental agreements that provide adequate interest under §1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467–2(b)(1)(ii) (agreements with deferred or prepaid rent that provide adequate stated interest at a single fixed rate).

(3) *Rental agreements subject to constant rental accrual*. Notwithstanding the provisions of paragraph (a)(2) of this section, this section applies to

rental agreements subject to constant rental accrual under §1.467–3.

(4) *Special rule in applying the provisions of §1.467–7(e) or (f).* Notwithstanding the provisions of paragraph (a)(2) of this section, this section applies to rental agreements that provide adequate interest under §1.467–2(b)(1)(i) or (ii), but only for purposes of applying the provisions of §1.467–7(e) (relating to dispositions of property subject to a section 467 rental agreement) or §1.467–7(f) (relating to assignments by lessees and lessee-financed renewals) to a transaction described therein. Further, for section 467 rental agreements that provide adequate interest under §1.467–2(b)(1)(i) or (ii), the section 467 interest that accrues on the section 467 loan balance after the sale, exchange, or other disposition under §1.467–7(e) or the assignment or renewal under §1.467–7(f) is the section 467 interest that accrues under the terms of the rental agreement (if any).

(b) *Principal balance*—(1) *In general*. Except as provided in paragraph (b)(2) of this section or in §1.467–7(e) or (f), the principal balance of the section 467 loan at the beginning of a rental period equals the fixed rent accrued in preceding rental periods—

(i) Increased by the interest on fixed rent includible in the gross income of the lessor for preceding rental periods and any amount payable by the lessor on or before the first day of the rental period as interest on prepaid fixed rent; and

(ii) Decreased by the interest on prepaid fixed rent includible in the gross income of the lessee for preceding rental periods and any amount payable by the lessee on or before the first day of the rental period as fixed rent or interest thereon.

(2) *Section 467 rental agreements that provide for prepaid fixed rent and adequate stated interest.* If a section 467 rental agreement calls for prepaid fixed rent and provides adequate interest under §1.467–2(b)(1)(iv), the principal balance of the section 467 loan at the beginning of a rental period equals the principal balance determined under paragraph (b)(1) of this section, plus the fixed rent accrued for that rental period.

(3) *Timing of payments.* For purposes of this paragraph (b), the day on which an amount is payable is determined under the rules of §1.467–1(j)(2).

(c) *Yield*—(1) *In general*—(i) *Method of determining yield.* Except as provided in paragraph (c)(2) of this section, the yield of a section 467 loan is the discount rate at which the sum of the present values of all amounts payable by the lessee as fixed rent and interest on fixed rent, plus the sum of the present values of all amounts payable by the lessor as interest on prepaid fixed rent, equals the sum of the present values of the fixed rent that accrues in accordance with §1.467–1(d)(2). The yield must be constant over the term of the section 467 rental agreement, and, when expressed as a percentage, must be calculated to at least two decimal places.

(ii) *Method of stating yield.* In determining the section 467 interest for a rental period, the yield of the section 467 loan must be stated appropriately by taking into account the length of the rental period. Section 1.1272–1(j) *Example 1* provides a formula for converting a yield based on a period of one length to an equivalent yield based on a period of a different length.

(iii) *Rounding adjustments.* Any adjustment necessary to eliminate the section 467 loan because of rounding the yield to two or more decimal places must be taken into account as section 467 interest for the final rental period determined as provided in paragraph (e) of this section.

(2) *Yield of section 467 rental agreements for which constant rental amount or proportional rental amount is computed.* In the case of a section 467 rental agreement to which §1.467–1(d)(2)(i) or (ii) applies, the yield of the section 467 loan equals 110 percent of the applicable Federal rate (based on a compounding period equal to the rental period).

(3) *Determination of present values.* The rules for determining present value in computing the yield of a section 467 loan are the same as those provided in §1.467–2(d) for computing the proportional rental amount.

(d) *Contingent payments.* Except as otherwise required under §1.467–6, contingent payments are not taken into account in calculating either the yield or the principal balance of a section 467 loan.

(e) *Section 467 rental agreements that call for payments before or after the lease term.* If a section 467 rental agreement calls for the payment of fixed rent or interest thereon before the beginning of the lease term, this section must be applied by treating the period beginning on the first day an amount is payable and ending on the day before the beginning of the first rental period of the lease term as one or more rental periods. If a rental agreement calls for the payment of fixed rent or interest thereon after the end of the lease term, this section must be applied by treating the period beginning on the day after the end of the last rental period of the lease term and ending on the last day an amount of fixed rent or interest thereon is payable as one or more rental periods. Rental period length for the period before the lease term or after the lease term is determined in accordance with the rules of §1.467–1(j)(5).

(f) *Examples.* The following examples illustrate the application of this section:

Example. (i)(A) A leases property to B for a three-year period beginning on January 1, 1998, and ending on December 31, 2000. The section 467 rental agreement has the following rent allocation schedule and payment schedule:

	Rent Allocation	*Payment*
1998	$400,000	
1999	600,000	
2000	800,000	$1,800,000

(B) The rental agreement requires a $1.8 million payment to be made on December 31, 2000, but does not provide for interest on deferred rent. Assume A and B choose the calendar year as the rental period length. Assume further that 110 percent of the applicable Federal rate based on annual compounding is 10 percent.

(ii) The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than $2,000,000 in rent (determined pursuant to §1.467–3(b)(1)(i)). Because the section 467 rental agreement does not provide adequate interest under §1.467–2(b) and is not subject to constant rental accrual, the fixed rent that accrues during each rental period is the proportional rental amount as described in §1.467–2(c). The proportional rental amounts for each rental period are as follows:

1998	$370,370.37
1999	555,555.56
2000	740,740.74

(iii) A section 467 loan arises at the beginning of the second rental period because the rent payable on or before that day (zero) is less than the fixed rent accrued under §1.467–1(d)(2) in all preceding rental periods ($370,370.37). Under paragraph (c)(2) of this section, the yield of the loan is equal to 110 percent of the applicable Federal rate (10 percent compounded annually). Because no payments are treated as made on or before the first day of the second rental period,

the principal balance of the loan at the beginning of the second rental period is $370,370.37. The interest for the second rental period on fixed rent is $37,037.04 (.10 × $370,370.37) and, under §1.467–1(e)(3), is treated as interest income of the lessor and as an interest expense of the lessee.

(iv) Because no payments are made on or before the first day of the third rental period, the principal balance of the loan at the beginning of the third rental period is equal to the fixed rent accrued during the first and second rental periods plus the lessor's interest income on fixed rent for the second rental period ($962,962.97 = $370,370.37 + $555,555.56 + $37,037.04). The interest for the third rental period on fixed rent is $96,296.30 (.10 × $962,962.97). Thus, the sum of the fixed rent and interest on fixed rent for the three rental periods is equal to the total amount paid over the lease term (first year fixed rent accrual, $370,370.37, plus second year fixed rent and interest accrual, $555,555.56 + $37,037.04, plus third year fixed rent and interest accrual, $740,740.74 + $96,296.30, equals $1,800,000). B takes the amounts of interest and rent into account as expense and A takes such amounts into account as income for the calendar years identified above, regardless of their respective methods of accounting.

Example 2. (i) The facts are the same as in *Example 1*, §1.467–2(f).

(ii)(A) Pursuant to paragraph (c)(1) of this section, the yield of the section 467 loan is 10.775078%, compounded annually. The following is a schedule of the rent allocable to each rental period during the lease term, the balance of the section 467 loan as of the end of each rental period (determined, in the case of the calendar year 2002, without regard to the single payment of rent and interest in the amount of $620,000 payable on the last day of the lease term), and the interest on the section 467 loan allocable to each rental period:

Calendar Year	*Section 467 Interest*	*Section 467 Rent*	*Section 467 Loan Balance*
1988	$ 0	$100,000.00	$100,000.00
1999	10,775.08	100,000.00	210,775.08
2000	22,711.18	100,000.00	333,486.26
2001	35,933.41	100,000.00	469,419.67
2002	50,580.33	100,000.00	620,000.00

(B) C takes the amounts of interest and rent into account as expense and D takes such amounts into account as income for the calendar years identified above, regardless of their respective methods of accounting.

§1.467–5 Section 467 rental agreements with variable interest.

(a) *Variable interest on deferred or prepaid rent*—(1) *In general.* This section provides rules for computing section 467 rent and interest in the case of section 467 rental agreements providing variable interest. For purposes of this section, a rental agreement provides for variable interest if the rental agreement provides for stated interest that is paid or compounded at least annually at a rate or rates that meet the requirements of §1.1275–5(a)(3)(i)(A) or (B) and §1.1275–5(a)(4). If a section 467 rental agreement provides for interest that is neither variable interest nor determined by reference to a fixed rate, the amount of any interest will be treated as a contingent payment subject to §1.467–6.

(2) *Exceptions.* This section is not applicable to section 467 rental agreements that provide adequate interest under §1.467–2(b)(1)(i) (agreements with no deferred or prepaid rent) or §1.467–2(b)(1)(ii) (rental agreements with stated interest at a single fixed rate). The exceptions in this paragraph (a)(2) do not apply to rental agreements subject to constant rental accrual under §1.467–3.

(b) *Variable rate treated as fixed*—(1) *In general.* If a section 467 rental agreement provides variable interest—

(i) The fixed rate substitutes (determined in the same manner as under §1.1275–5(e) treating the agreement date as the issue date) for the variable rates of interest on prepaid or deferred fixed rent provided by the rental agreement must be used in computing the proportional rental amount under §1.467–2(c), the constant rental amount under §1.467–3(d), the principal balance of a section 467 loan under §1.467–4(b), and the yield of a section 467 loan under §1.467–4(c); and

(ii) The interest on fixed rent for any rental period is equal to the amount that would be determined under §1.467–1(e)(2) if the section 467 rental agreement did not provide variable interest, using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable rates called for by the rental agreement, plus the variable interest adjustment amount provided in paragraph (b)(2) of this section.

(2) *Variable interest adjustment amount*—(i) *In general.* The variable interest adjustment amount for a rental period equals the difference between—

(A) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement; and

(B) The amount of interest that, without regard to section 467, would have accrued during the rental period under the terms of the section 467 rental agreement using the fixed rate substitutes determined under paragraph (b)(1)(i) of this section in place of the variable interest rates called for by the rental agreement.

(ii) *Sign of adjustment.* If the amount determined under paragraph (b)(2)(i)(A) of this section is greater than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is positive. If the amount determined under paragraph (b)(2)(i)(A) of this section is less than the amount determined under paragraph (b)(2)(i)(B) of this section, the variable interest adjustment amount is negative.

(3) *Section 467 loan balance.* The variable interest adjustment amount is not taken into account in determining the principal balance of a section 467 loan under §1.467–4(b). Instead, the section 467 loan balance is computed as if all amounts payable under the section 467 rental agreement were based on the fixed rate substitutes determined under paragraph (b)(1)(i) of this section.

(c) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) X and Y enter into a section 467 rental agreement for the lease of personal property beginning on January 1, 1998, and ending on December 31, 2000. It allocates $100,000 of rent to 1998, $200,000 to 1999, and $100,000 to 2000, and requires the lessee to pay all $400,000 of rent on December 31, 2000. The rental agreement requires the accrual of interest on unpaid accrued rent at two different qualified floating rates (as defined in §1.1275–5(b)), one for 1999 and the other for 2000, such interest to be paid on December 31 of the year it accrues. The rental agreement provides that the qualified floating rate is set at a current value within the meaning of §1.1275–5(a)(4). Assume that on the agreement date, 110 percent of the applicable Federal rate is 10 percent, compounded annually.

(ii) The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than $2,000,000 in rent (determined pursuant to §1.467–3(b)(1)(i)). To determine if the section 467 rental agreement provides for adequate interest under §1.467–2(b), §1.467–2(b)(2) requires the use of fixed rate substitutes (in this example determined in the same manner as under §1.1275–5(e)(3)(i) treating the agreement date as the issue date) in place of the variable rates called for by the rental agreement. Assume that on the agreement date the qualified floating rates, and therefore the fixed rate substitutes, relating to 1999 and 2000 are 10 and 15 percent compounded annually. Taking into account the fixed rate substitutes, the sum of the present values of all amounts payable by the lessee as fixed rent and interest thereon is greater than the sum of the present values of the fixed rent allocated to each rental period. Accordingly, the rental agreement provides adequate interest under §1.467–2(b)(1)(iii) and the fixed rent accruing in

each calendar year during the rental agreement is the fixed rent allocated under the rental agreement.

(iii) Because the section 467 rental agreement provides for variable interest on unpaid accrued fixed rent at qualified floating rates and the qualified floating rates are set at a current value, the requirements of §1.1275–5(a)(3)(i)(A) and (4) are met and the rental agreement provides for variable interest within the meaning of paragraph (a)(1) of this section. Therefore, under paragraph (b)(1)(i) of this section, the yield of the section 467 loan is computed based on the fixed rate substitutes. Under §1.467–4(c), the constant yield (rounded to two decimal places) equals 13.63 percent compounded annually. Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the principal balance of the section 467 loan, for each calendar year during the lease term, are as follows:

	Accrued Rent	*Accrued Interest*	*Projected Payment*	*Cumulative Loan*
1998	$100,000	$ 0	$ 0	$100,000
1999	200,000	13,630	(10,000)	303,630
2000	100,000	41,370	(445,000)	0

(iv) To compute the actual reported interest on fixed rent for each calendar year, the variable interest adjustment amount, as described in paragraph (b)(2) of this section, must be added to the accrued interest determined in paragraph (iii) of this *Example 1.* Assume that the variable rates for 1999 and 2000 are actually 11 and 14 percent, respectively. Without regard to section 467, the interest that would have accrued during each calendar year under the terms of the section 467 rental agreement, and the interest that would have accrued under the terms of the rental agreement using the fixed rate substitutes determined under paragraph (b)(1)(i) are as follows:

	Accrued Interest Under Rental Agreement	*Accrued Interest Using Fixed Rate Substitutes*
1998	$ 0	$ 0
1999	11,000	10,000
2000	42,000	45,000

(v) Under paragraph (b)(2) of this section, the variable interest adjustment amount is $1,000 ($11,000 – $10,000) for 1999 and is –$3,000 ($42,000 – $45,000) for 2000. Thus, under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 1999 is $14,630 ($13,630 + $1,000) and for 2000 is $38,370 ($41,370 – $3,000).

Example 2. (i) The facts are the same as in *Example 1* except that 110 percent of the applicable Federal rate is 15 percent compounded annually and the section 467 rental agreement does not provide adequate interest under §1.467–2(b). Consequently, the fixed rent for each calendar year during the lease is the proportional rental amount.

(ii) The sum of the present values of the fixed rent provided for each calendar year during the lease term, discounted at 15 percent compounded annually, equals $303,936.87.

(iii)(A) Paragraph (b)(1)(i) of this section requires the proportional rental amount to be computed based on the assumption that interest will accrue and be paid based on the fixed rate substitutes. Thus, the sum of the present values of the projected payments under the section 467 rental agreement equals $300,156.16, computed as follows:

$ 10,000/(1.15)^2	=	$ 7,561.44
445,000/(1.15)^3	=	$300,156.16

(B) The fraction for computing the proportional rental amount equals .9875609 ($300,156.16/$303,936.87).

(iv) Based on the fixed rate substitutes, the fixed rent, interest on fixed rent, and the balance of the section 467 loan for each calendar year during the lease term are as follows:

	Proportional Rent	*Accrued Interest*	*Projected Payment*	*Cumulative Loan*
1998	$ 98,756.09	$ 0.00	$ 0	$ 98,756.09
1999	197,512.18	14,813.41	(10,000)	301,081.68
2000	98,756.09	45,162.23	(445,000)	0.00

(v) The variable interest adjustment amount in this example is the same as in *Example 1.* Under paragraph (b)(1)(ii) of this section, the actual interest on fixed rent for 1999 is $15,813.41 ($14,813.41 + $1,000) and for 2000 is $42,162.23 ($45,162.23 – $3,000).

§1.467–6 Section 467 rental agreements with contingent payments. [Reserved]

§1.467–7 Section 467 recapture and other rules relating to dispositions.

(a) *Section 467 recapture.* Notwithstanding any other provision of the Code, except as provided in paragraph (c) of this section, a lessor disposing of property in a transaction to which this section applies must recognize the recapture amount (determined under paragraph (b) of this section) and treat that amount as ordinary income. This section applies to any disposition of property subject to a section 467 rental agreement that—

(1) Is a leaseback (as defined in §1.467–3(b)(2)) or a long-term agreement (as defined in §1.467–3(b)(3));

(2) Is not disqualified under §1.467–3(b)(1); and

(3) Allocates to any rental period fixed rent that, when annualized, exceeds the annualized fixed rent allocated to any preceding rental period.

(b) *Recapture Recapture amount*—(1) *In general.* The recapture amount for a disposition is the lesser of—

(i) The prior understated inclusions (determined under paragraph (b)(2) of this section); or

(ii) The section 467 gain (determined under paragraph (b)(3) of this section).

(2) *Prior understated inclusions*—(i) *In general.* The prior understated inclusions are the excess (if any) of—

(A) The aggregate amount of section 467 rent and section 467 interest for the period during which the lessor held the property, determined as if the section 467 rental agreement were a disqualified leaseback or long-term agreement; over

(B) The aggregate amount of section 467 rent and section 467 interest accrued by the lessor during that period.

(ii) *Partial rental periods.* For purposes of this paragraph (b)(2), the aggregate amounts described in paragraph (b)(2)(i)(A) and (B) of this section include a ratable portion of the section 467 rent and section 467 interest for any partial rental period during which the lessor held the property.

(3) *Section 467 gain*—(i) *In general.* Except as otherwise provided in paragraph (b)(3)(ii) of this section, the section 467 gain is the excess (if any) of—

(A) The amount realized from the disposition; over

(B) The sum of the adjusted basis of the property and the amount of any gain from the disposition that is treated as ordinary income under any provision of subtitle A of the Code other than section 467(c) (*e.g.,* section 1245 or 1250).

(ii) *Certain dispositions.* In the case of a disposition that is not a sale, exchange, or involuntary conversion, the section 467 gain is the excess (if any) of the fair market value of the property on the date of disposition over the amount determined under paragraph (b)(3)(i)(B) of this section.

(c) *Special rules*—(1) *Gifts.* Paragraph (a) of this section does not apply to a disposition by gift. However, see paragraph (c)(4) of this section for dispositions by transferees.

(2) *Dispositions at death.* Paragraph (a) of this section does not apply to a disposition if the basis of the property in the hands of the transferee is determined under section 1014(a). In the case of items constituting income in respect of a decedent, see section 691.

(3) *Certain tax-free exchanges*—(i) *In general.* The recapture amount in the case of a disposition to which this paragraph (c)(3) applies is limited to the amount of gain recognized to the transferor (determined without regard to paragraph (a) of this section), reduced by the amount of any gain from the disposition that is treated as ordinary income under any provision of

subtitle A of the Code other than section 467(c).

(ii) *Dispositions covered.* This paragraph (c)(3) applies to a disposition of property if the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 721, or 731.

(4) *Dispositions by transferee.* If the recapture amount with respect to a disposition of property (the first disposition) is limited under paragraph (c)(1) or (3) of this section and the transferee subsequently disposes of the property in a transaction to which this section applies, the amount described in paragraph (b)(2)(i)(A) of this section must be increased for purposes of determining the recapture amount for such subsequent disposition by the excess (if any) of—

(i) The recapture amount on the first disposition, determined without regard to the limitations of paragraphs (c)(1) and (3) of this section; over

(ii) The recapture amount on the first disposition determined after application of such limitations.

(5) *Like-kind exchanges and involuntary conversions.* If property is disposed of or converted and, before the application of paragraph (a) of this section, gain is not recognized in whole or in part under section 1031 or 1033, then the amount of section 467 gain taken into account by the lessor is limited to the sum of—

(i) The amount of gain recognized on the disposition or conversion of the property (determined without regard to paragraph (a) of this section); plus

(ii) The fair market value of property acquired that is not subject to a section 467 rental agreement and that is not taken into account under paragraph (c)(5)(i) of this section.

(6) *Installment sales.* In the case of an installment sale of property to which paragraph (a) of this section applies—

(i) The recapture amount is recognized and treated as ordinary income in the year of the disposition; and

(ii) Any gain in excess of the recapture amount shall be reported under the installment method of accounting if and to the extent that method is otherwise available under section 453.

(7) *Dispositions covered by sections 170(e), 341(e)(12), or 751(c).* For purposes of sections 170(e), 341(e)(12), and 751(c), amounts treated as ordinary income under paragraph (a) of this section must be treated in the same manner as amounts treated as ordinary income under section 1245 or 1250.

(d) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) X and Y enter into a section 467 rental agreement for a 5-year lease of personal property beginning on January 1, 1997, and ending on December 31, 2001. The rental agreement provides that $0 of rent is allocated to 1997, 1998, and 1999, and $175,000 is allocated to each of the years 2000 and 2001. The rental agreement provides that the calendar year will be the rental period and that the rent allocated to each calendar year is payable on the last day of that calendar year. Assume that both X and Y are calendar year taxpayers and that 110 percent of the applicable Federal rate is 11 percent, compounded annually. Assume further that the rental agreement is a long-term agreement (as defined in §1.467–3(b)(3)). The rental agreement is not a disqualified leaseback or long-term agreement because it does not provide for the payment of more than $2,000,000 in rent (determined pursuant to §1.467–3(b)(1)(i)). Therefore, the fixed rent allocated under §1.467–1(c)(2)(ii) is zero for the first three rental periods and $175,000 for the fourth and fifth rental periods.

(ii) On December 31, 1999, X sells the property subject to the section 467 rental agreement to an unrelated person for $990,000. At the time of the sale, X's adjusted basis in the property is $550,000. Thus, X's gain on the sale of the property is $440,000. Assume that none of this gain would be treated as ordinary income under any provision of the Internal Revenue Code other than section 467(c). Under paragraph (a) of this section, X is required to take the recapture amount into account as ordinary income. Under paragraph (b) of this section, the recapture amount is the lesser of the prior understated inclusions or the section 467 gain.

(iii)(A) In computing the prior understated inclusions under paragraph (b)(2), assume that the section 467 rent and section 467 interest (based on constant rental accrual) would be taken into account as follows if the section 467 rental agreement were a disqualified long-term agreement:

	Section 467 Rent	*Section 467 Interest*
1997	$59,290.59	$ 0
1998	59,290.59	6,521.96
1999	59,290.59	13,761.35
2000	59,290.59	21,797.06
2001	59,290.59	11,466.68

(B) The aggregate amount of the section 467 rent and section 467 interest (based on constant rental accrual) for 1997, 1998, and 1999 is $198,155.08 ((3 × $59,290.59) + $6,521.96 + $13,761.35). Since X did not take any section 467 rent or section 467 interest into account in 1997, 1998, and 1999, the prior understated inclusions are also $198,155.08. Since none of the gain is treated as ordinary income under any provision of the Code other than section 467(c), the entire amount of gain ($440,000) is section 467 gain. Accordingly, the recapture amount (, the lesser of the prior understated inclusions or the section 467 gain) treated as ordinary income is $198,155.08.

Example 2. (i) The facts are the same as in *Example 1* except that the section 467 rental agreement specifies that rents accrue and are paid in the following pattern:

	Allocation	*Payment*
1997	$60,000	$ 0
1998	65,000	0
1999	70,000	0
2000	75,000	175,000
2001	80,000	175,000

(ii)(A) Assume the section 467 rental agreement does not provide for adequate interest under §1.467–2(b), and, therefore, the fixed rent for a rental period is the proportional rental amount. *See* §1.467–1(d)(2)(ii). Assume that, under §1.467–2(c), the following amounts would be required to be taken into account:

	Section 467 Rent	*Section 467 Interest*
1997	$51,585.97	$ 0
1998	55,884.80	5,674.46
1999	60,183.63	12,445.98
2000	64,482.46	20,435.23
2001	68,781.28	10,526.19

(B) The amount of section 467 rent and section 467 interest taken into account by A for 1997, 1998, and 1999 is $185,774.84. Thus, the prior understated inclusions are $12,380.24 (the excess of the aggregate amount of section 467 rent and section 467 interest, based on constant rental accrual, for these three years, $198,155.08, over the aggregate amount of section 467 rent and section 467 interest actually taken into account, $185,774.84). Since this amount is less than the section 467 gain, the recapture amount treated as ordinary income is also $12,380.24.

(e) *Other rules relating to dispositions*—(1) *In general.* If property subject to a section 467 rental agreement is sold, exchanged, or otherwise disposed of, the section 467 rent for a period is taken into account by the owner of the property during the period. The lessee, however, must continue to take section 467 rent and section 467 interest into account without regard to the change of ownership.

(2) *Treatment of section 467 loan.* If there is a sale, exchange, or other disposition of property subject to a section 467 rental agreement (the transfer), the following rules apply in determining the amount of the section 467 loan for the period after the transfer, the amount realized by the transferor, and the transferee's basis in the property:

(i) The beginning balance of the transferor's section 467 loan is equal to the net present value at the time of the transfer of all subsequent amounts payable as fixed rent and interest on fixed rent to the transferor and all subsequent amounts payable as interest on prepaid fixed rent by the transferor.

The transferor must continue to take into account interest on the transferor's section 467 loan balance after the date of the transfer.

(ii) The beginning balance of the transferee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the transfer reduced (below zero, if appropriate) by the beginning balance of the transferor's section 467 loan. Amounts payable to the transferor are not taken into account in adjusting the transferee's section 467 loan balance.

(iii) If the beginning balance of the transferee's section 467 loan is negative, the transferor and transferee must treat the balance as a liability that is either assumed in connection with the transfer of the property or secured by the property acquired subject to the liability. If the beginning balance of the transferee's section 467 loan is positive, the transferor and transferee must treat the balance as an additional asset acquired in connection with the transfer of the property. In the case of a positive beginning balance of the transferee's section 467 loan, the transferee will have an initial cost basis in the section 467 loan equal to the lesser of the beginning balance of the loan or the aggregate consideration for the transfer of the property subject to the section 467 rental agreement and the transfer of the transferor's interest in the section 467 loan.

(3) *Special rules for transfers in certain nonrecognition transactions.* [Reserved]

(f) *Treatment of assignments by lessee and lessee-financed renewals*—(1) *Substitute lessee use.* If a lessee assigns its interest in a section 467 rental agreement to a substitute lessee or a period when a substitute lessee has the use of property subject to a rental agreement is otherwise included in the lease term under §1.467–1(h), the section 467 rent for a period is taken into account by the person having the use of the property during the period. In addition, the following rules apply in determining the amount of the section 467 loan for the period when the substitute lessee has use of the property and in computing the taxable income of the lessee and substitute lessee—

(i) The beginning balance of the lessee's section 467 loan is equal to the net present value, as of the date on which the substitute lessee first has use of the property, of all amounts subsequently payable by the lessee as fixed rent and interest on fixed rent and all amounts subsequently payable as interest on prepaid fixed rent to the lessee. For purposes of this paragraph (f), any amount otherwise payable by the lessee shall not be treated as an amount subsequently payable by the lessee to the extent that such payment, if made by the lessee, would give rise to a right of contribution or other similar claim against the substitute lessee or any other person. The lessee must continue to take into account interest on the lessee's section 467 loan balance after the substitute lessee first has use of the property.

(ii) The beginning balance of the substitute lessee's section 467 loan is equal to the principal balance of the section 467 loan immediately before the substitute lessee first has use of the property reduced (below zero, if appropriate) by the beginning balance of the lessee's section 467 loan. Amounts payable by the lessee to any person other than the substitute lessee (or a related person) or payable to the lessee by any person other than the substitute lessee (or a related person) are not taken into account in adjusting the substitute lessee's section 467 loan balance.

(iii) If the beginning balance of the substitute lessee's section 467 loan is positive, the beginning balance is treated as— (A) Gross income of the lessee for the taxable year in which the substitute lessee first has use of the property; and

(B) A liability that is either assumed in connection with the transfer of the leasehold interest to the substitute lessee or secured by property acquired subject to the liability.

(iv) If the beginning balance of the substitute lessee's section 467 loan is negative—

(A) The beginning balance is treated as an amount incurred by the lessee for the taxable year in which the substitute lessee first has use of the property; and

(B) Repayments of the beginning balance are items of gross income of the substitute lessee in the taxable year in which the repayment occurs (determined by applying any repayment first to the beginning balance of the substitute lessee's section 467 loan).

(v) For purposes of paragraph (f)(1)(iv)(B) of this section, repayments occur as the negative balance is amortized through the net accrual of rent and negative interest.

(2) *Lessor use.* If a period when the lessor has the use of property subject to a section 467 rental agreement is included in the lease term under §1.467–1(h), the section 467 rent for the period is not taken into account and the lessor is treated as a substitute lessee for purposes of paragraph (f)(1) of this section.

(3) *Special rules for transfers in certain nonrecognition transactions.* [Reserved]

§1.467–8 Effective date.

Sections 1.467–1 through 1.467–7 are effective for—

(a) Rental agreements entered into after the date these regulations are published as final regulations in the **Federal Register**; and

(b) Disqualified leasebacks and long-term agreements entered into after June 3, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 31, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 3, 1996, 61 F.R. 27834)

Continued Use of Certain Estate and Gift Tax Forms

Announcement 96–62

The following U.S. estate and gift tax forms and their related instructions are being revised. The new revisions should be available by October 1996.

Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (Rev. August 1993)

Form 706–A, United States Additional Estate Tax Return (Rev. May 1993)

Form 706–NA, United States Estate (and Generation-Skipping Transfer) Tax Return, estate of nonresident not a citizen of the United States (Rev. September 1993)

Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return (Rev. November 1993)

Form 709–A, United States Short Form Gift Tax Return (Rev. July 1993).

The IRS has received approval from the Office of Management and Budget to continue to use these forms even though their expiration dates have elapsed. Therefore, until the new revisions are available, filers can still use the current forms and instructions. Forms can be ordered by calling 1-800-TAX-FORM (1-800-829-3676).

Announcement of the Disbarment, Suspension, and Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Bruender, Lawrence	Lesueur, MN	Attorney	Indefinite from April 18, 1996
Pallman, James J.	New Haven, CT	CPA	April 19, 1996 to October 18, 1996
Pribble Jr., William C.	Minneapolis, MN	Attorney	Indefinite from May 1, 1996
Pyburn, Richard E.	Downers Grove, IL	CPA	May 1, 1996 to October 31, 1997
Scalise, James J.	New Britain, CT	Attorney	May 1, 1996 to July 31, 1996
Kieldaisch, Dale W.	Manteno, IL	CPA	May 1, 1996 to October 31, 1996
Ogorek, Charolotte F.	Park Ridge, IL	CPA	May 3, 1996 to July 2, 1996
Korman, Steven B.	Mulford, CT	CPA	May 3, 1996 to February 2, 1997
Myers, Donald L.	Olney, MD	CPA	May 7, 1996 to May 6, 1998
Sharrett, William R.	Paradise, CA	Enrolled Agent	May 8, 1996 to November 7, 1996
Cornwell, Douglas S.	Norwalk, CT	CPA	May 10, 1996 to November 9, 1996
Chang, Sun Kun	McLean, VA	Enrolled Agent	May 13, 1996 to July 12, 1996
Cariveau, Stewart	Minneapolis, MN	CPA	May 30, 1996 to August 29, 1996
Carter, Gary E.	Ashdown, AR	CPA	June 1, 1996 to August 31, 1996
Underwood, Wendell L.	Sedalia, MO	CPA	June 1, 1996 to July 31, 1996
Candiloro, James A.	Glastonbury, CT	CPA	June 1, 1996 to November 30, 1996
Schwartz, Leonard J.	Danbury, CT	Enrolled Agent	June 1, 1996 to February 28 1997
Forrester, Donald F.	Fairfield, OH	CPA	Indefinite from June 4, 1996
Shade, Stephen E.	Clearwater, FL	Enrolled Agent	June 8, 1996 to May 7, 1997
Woods, James G.	Huntington, CT	CPA	July 1, 1996 to June 30, 1997
Grove, Michael J.	Alliance, OH	CPA	July 1, 1996 to June 30, 1997
Jenkins, Frank	Montgomery, AL	CPA	July 1, 1996 to December 31, 1996
Brewton III, George W.	Greenville, MS	CPA	July 1, 1996 to September 30, 1996
Fischer, Randall E.	Lombard, IL	CPA	July 1, 1996 to September 30, 1996
Rhoney, Brian	Wheaton, IL	CPA	July 1, 1996 to December 31, 1996
Devereux, Michael J.	Florissant, MO	CPA	July 1, 1996 to March 31, 1997
Cranston, Robert S.	Saugerties, NY	CPA	July 1, 1996 to December 31, 1996
Miller, Dwight W.	Overland Pk, KS	CPA	July 1, 1996 to June 30, 1997
Beck, Clyde E.	Salina, KS	CPA	July 1, 1996 to October 31, 1996
Seal, Ernest E.	Cleveland, MS	CPA	August 1, 1996 to July 31, 1998
Dicker, Joseph W.	Minneapolis, MN	Attorney	August 1, 1996 to October 31, 1996

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Bushta, Patrick C.	Sacramento, CA	CPA	April 18, 1996
Hart, Joel S.	Beaumont, TX	CPA	April 19, 1996
Riggs, Patricia A.	Stockton, CA	Enrolled Agent	April 19, 1996
Hammontree, Richard F.	Ogunquit, ME	CPA	April 27, 1996
Otto, Judith M.	Tucson, AZ	Enrolled Agent	May 18, 1996

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified, below*).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified,* above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1]A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1996–1 through 1996–26, will be found in Internal Revenue Bulletin 1996–27, dated July 1, 1996.

[1]A cumulative finding list for previously published items mentioned in Internal Revenue Bulletins 1996–1 through 1996–26 will be found in Internal Revenue Bulletin 1996–27, dated July 1, 1996.