to any debt instrument that evidences a demand loan that is a below-market loan described in section 7872(c)(1).

(iii) *Certain transfers subject to section 1041.* Section 1274 does not apply to any debt instrument issued in consideration for a transfer of property subject to section 1041 (relating to transfers of property between spouses or incident to divorce).

(c) *Examples.* The following examples illustrate the rules of this section.

Example 1. Single stated rate paid semiannually. A debt instrument issued in consideration for the sale of nonpublicly traded property in a transaction that is not a potentially abusive situation calls for the payment of a principal amount of $1,000,000 at the end of a 10-year term and 20 semiannual interest payments of $60,000. Assume that the test rate of interest is 12 percent, compounded semiannually. The debt instrument is not subject to section 1274 because it provides for interest equal to the test rate and all interest payable on the instrument is qualified stated interest.

Example 2. Sale of farm for debt instrument with contingent interest—(i) *Facts.* On July 1, 1995, A, an individual, sells to B land used as a farm within the meaning of section 6420(c)(2). As partial consideration for the sale, B issues a debt instrument calling for a single $500,000 payment due in 10 years unless profits from the land in each of the 10 years preceding maturity of the debt instrument exceed a specified amount, in which case B is to make a payment of $1,200,000. The debt instrument does not provide for interest.

(ii) *Total payments may exceed $1,000,000.* Even though the total payments ultimately payable under the contract may be less than $1,000,000, at the time of the sale or exchange it cannot be determined that the sales price cannot exceed $1,000,000. Thus, the sale of the land used as a farm is not an excepted transaction described in section 1274(c)(3)(A).

Example 3. Sale between related parties subject to section 483(e)—(i) *Facts.* On July 1, 1995, A, an individual, sells land (not used as a farm within the meaning of section 6420(c)(2)) to A's child B for $650,000. In consideration for the sale, B issues a 10-year debt instrument to A that calls for a payment of $650,000. No other consideration is given. The debt instrument does not provide for interest.

(ii) *Treatment of debt instrument.* For purposes of section 483(e), the $650,000 debt instrument is treated as two separate debt instruments: a $500,000 debt instrument and a $150,000 debt instrument. The $500,000 debt instrument is subject to section 483(e), and accordingly is covered by the exception from section 1274 described in section 1274(c)(3)(F). Because the amount of the payments due as consideration for the sale exceeds $250,000, however, the $150,000 debt instrument is subject to section 1274.

[T.D. 8517, 59 FR 4820, Feb. 2, 1994]

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

(a) *In general.* If section 1274 applies to a debt instrument, section 1274 and this section determine the issue price of the debt instrument. For rules relating to the determination of the amount and timing of OID to be included in income, see section 1272 and the regulations thereunder.

(b) *Issue price*—(1) *Debt instruments that provide for adequate stated interest; stated principal amount.* The issue price of a debt instrument that provides for adequate stated interest is the stated principal amount of the debt instrument. For purposes of section 1274, the stated principal amount of a debt instrument is the aggregate amount of all payments due under the debt instrument, excluding any amount of stated interest. Under §1.1273–2(g)(2)(ii), however, the stated principal amount of a debt instrument is reduced by any payment from the buyer- borrower to the seller-lender that is designated as interest or points. See *Example 2* of §1.1273–2(g)(5).

(2) *Debt instruments that do not provide for adequate stated interest; imputed principal amount.* The issue price of a debt instrument that does not provide for adequate stated interest is the imputed principal amount of the debt instrument.

(3) *Debt instruments issued in a potentially abusive situation; fair market value.* Notwithstanding paragraphs (b)(1) and (b)(2) of this section, in the case of a debt instrument issued in a potentially abusive situation (as defined in §1.1274–3), the issue price of the debt instrument is the fair market value of the property received in exchange for the debt instrument, reduced by the fair market value of any consideration other than the debt instrument issued in consideration for the sale or exchange.

(c) *Determination of whether a debt instrument provides for adequate stated interest*—(1) *In general.* A debt instrument provides for adequate stated interest if

its stated principal amount is less than or equal to its imputed principal amount. Imputed principal amount means the sum of the present values, as of the issue date, of all payments, including payments of stated interest, due under the debt instrument (determined by using a discount rate equal to the test rate of interest as determined under §1.1274–4). If a debt instrument has a single fixed rate of interest that is paid or compounded at least annually, and that rate is equal to or greater than the test rate, the debt instrument has adequate stated interest.

(2) *Determination of present value.* The present value of a payment is determined by discounting the payment from the date it becomes due to the date of the sale or exchange at the test rate of interest. To determine present value, a compounding period must be selected, and the test rate must be based on the same compounding period.

(d) *Treatment of certain options.* This paragraph (d) provides rules for determining the issue price of a debt instrument to which section 1274 applies (other than a debt instrument issued in a potentially abusive situation) that is subject to one or more options described in both paragraphs (c)(1) and (c)(5) of §1.1272–1. Under this paragraph (d), an issuer will be deemed to exercise or not exercise an option or combination of options in a manner that minimizes the instrument's imputed principal amount, and a holder will be deemed to exercise or not exercise an option or combination of options in a manner that maximizes the instrument's imputed principal amount. If both the issuer and the holder have options, the rules of this paragraph (d) are applied to the options in the order that they may be exercised. Thus, the deemed exercise of one option may eliminate other options that are later in time. See §1.1272–1(c)(5) to determine the debt instrument's yield and maturity for purposes of determining the accrual of OID with respect to the instrument.

(e) *Mandatory sinking funds.* In determining the issue price of a debt instrument to which section 1274 applies (other than a debt instrument issued in a potentially abusive situation) and that is subject to a mandatory sinking fund provision described in §1.1272–1(c)(3), the mandatory sinking fund provision is ignored.

(f) *Treatment of variable rate debt instruments*—(1) *Stated interest at a qualified floating rate*—(i) *In general.* For purposes of paragraph (c) of this section, the imputed principal amount of a variable rate debt instrument (within the meaning of §1.1275–5(a)) that provides for stated interest at a qualified floating rate (or rates) is determined by assuming that the instrument provides for a fixed rate of interest for each accrual period to which a qualified floating rate applies. For purposes of the preceding sentence, the assumed fixed rate in each accrual period is the greater of—

(A) The value of the applicable qualified floating rate as of the first date on which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated; or

(B) The value of the applicable qualified floating rate as of the date on which the sale or exchange occurs.

(ii) *Interest rate restrictions.* Notwithstanding paragraph (f)(1)(i) of this section, if, as a result of interest rate restrictions (such as an interest rate cap), the expected yield of the debt instrument taking the restrictions into account is significantly less than the expected yield of the debt instrument without regard to the restrictions, the interest payments on the debt instrument (other than any fixed interest payments) are treated as contingent payments. Reasonably symmetric interest rate caps and floors, or reasonably symmetric governors, that are fixed throughout the term of the debt instrument do not result in the debt instrument being subject to this rule.

(2) *Stated interest at a single objective rate.* For purposes of paragraph (c) of this section, the imputed principal amount of a variable rate debt instrument (within the meaning of §1.1275–5(a)) that provides for stated interest at a single objective rate is determined by treating the interest payments as contingent payments.

(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.

(h) *Examples.* The following examples illustrate the rules of this section. Each example assumes a 30-day month, 360-day year. In addition, each example assumes that the debt instrument is not a qualified debt instrument (as defined in section 1274A(b)) and is not issued in a potentially abusive situation.

Example 1. Debt instrument without a fixed rate over its entire term—(i) *Facts.* On January 1, 1995, A sells nonpublicly traded property to B for a stated purchase price of $3,500,000. In consideration for the sale, B makes a down payment of $500,000 and issues a 10-year debt instrument with a stated principal amount of $3,000,000, payable at maturity. The debt instrument calls for no interest in the first 2 years and interest at a rate of 15 percent payable annually over the remaining 8 years of the debt instrument. The first interest payment of $450,000 is due on December 31, 1997, and the last interest payment is due on December 31, 2004, together with the $3,000,000 payment of principal. Assume that the test rate of interest applicable to the debt instrument is 10.5 percent, compounded annually.

(ii) *Applicability of section 1274.* Because the debt instrument does not provide for any interest during the first 2 years, none of the interest on the debt instrument is qualified stated interest. Therefore, the issue price of the debt instrument is determined under section 1274. See §1.1274–1(b)(1). If the debt instrument has adequate stated interest, the issue price of the instrument is its stated principal amount. Otherwise, the issue price of the debt instrument is its imputed principal amount. The debt instrument has adequate stated interest only if the stated principal amount is less than or equal to the imputed principal amount.

(iii) *Determination of imputed principal amount.* To compute the imputed principal amount of the debt instrument, all payments due under the debt instrument are discounted back to the issue date at 10.5 percent, compounded annually, as follows:

(A) The present value of the $3,000,000 principal payment payable on December 31, 2004, is $1,105,346.59, determined as follows:

$$\$1{,}105{,}346.59 = \frac{\$3{,}000{,}000}{(1+.105/1)^{10}}$$

(B) The present value of the eight interest payments of $450,000 as of January 1, 1997, is $2,357,634.55, determined as follows:

$$\$2{,}357{,}634.55 = \$450{,}000 \times \frac{1-(1+.105/1)^{-8}}{(.105/1)}$$

(C) The present value of this interim amount as of January 1, 1995, is $1,930,865.09, determined as follows:

$$\$1{,}930{,}865.09 = \frac{\$2{,}357{,}634.55}{(1+.105/1)^{2}}$$

(iv) *Determination of issue price.* The debt instrument's imputed principal amount (that is, the present value of all payments due under the debt instrument) is $3,036,211.68 ($1,105,346.59+$1,930,865.09). Because the stated principal amount ($3,000,000) is less than the imputed principal amount, the debt instrument provides for adequate stated interest. Therefore, the issue price of the debt instrument is its stated principal amount ($3,000,000).

Example 2. Debt instrument subject to issuer call option—(i) *Facts.* On January 1, 1995, in partial consideration for the sale of nonpublicly traded property, H corporation issues to G a 10-year debt instrument, maturing on January 1, 2005, with a stated principal amount of $10,000,000, payable on that date. The debt instrument provides for annual payments of interest of 8 percent for the first 5 years and 14 percent for the final 5 years, payable on January 1 of each year, beginning on January 1, 1996. In addition the debt instrument provides H with the unconditional option to call (prepay) the debt instrument at the end of 5 years for its stated principal amount of $10,000,000. Assume that the Federal mid-term and long-term rates applicable to the sale based on annual compounding are 9 percent and 10 percent, respectively.

(ii) *Option presumed exercised.* Assuming exercise of the call option, the imputed principal amount as determined under paragraph (d) of this section is $9,611,034.87 (the present value of all of the payments due within a 5-

year term discounted at a test rate of 9 percent, compounded annually). Assuming nonexercise of the call option, the imputed principal amount is $10,183,354.78 (the present value of all of the payments due within a 10-year term discounted at a test rate of 10 percent, compounded annually). For purposes of determining the imputed principal amount, the option is presumed exercised because the imputed principal amount, assuming exercise of the option, is less than the imputed principal amount, assuming the option is not exercised. Because the option is presumed exercised, the debt instrument fails to provide for adequate stated interest because the imputed principal amount ($9,611,034.87) is less than the stated principal amount ($10,000,000). Thus, the issue price of the debt instrument is $9,611,034.87.

Example 3. Variable rate debt instrument with a single rate over its entire term—(i) *Facts.* On January 1, 1995, A sells B nonpublicly traded property. In partial consideration for the sale, B issues a debt instrument in the principal amount of $1,000,000, payable in 5 years. The debt instrument calls for interest payable monthly at a rate of 1 percentage point above the average prime lending rate of a major bank for the month preceding the month of the interest payment. Assume that the test rate of interest applicable to the debt instrument is 10.5 percent, compounded monthly. Assume also that 1 percentage point above the prime lending rate of the designated bank on the date of the sale is 12.5 percent, compounded monthly, which is greater than 1 percentage point above the prime lending rate of the designated bank on the first date on which there is a binding written contract that substantially sets forth the terms under which the sale is consummated.

(ii) *Debt instrument has adequate stated interest.* The debt instrument is a variable rate debt instrument (within the meaning of §1.1275–5) that provides for stated interest at a qualified floating rate. Under paragraph (f)(1)(i) of this section, the debt instrument is treated as if it provided for a fixed rate of interest equal to 12.5 percent, compounded monthly. Because the test rate of interest is 10.5 percent, compounded monthly, the debt instrument provides for adequate stated interest.

Example 4. Debt instrument with a capped variable rate. On July 1, 1995, A sells nonpublicly traded property to B in return for a debt instrument with a stated principal amount of $10,000,000, payable on July 1, 2005. Interest is payable on July 1 of each year, beginning on July 1, 1996, at the Federal short-term rate for June of the same year. The debt instrument provides, however, that the interest rate cannot rise above 8.5 percent, compounded annually. Assume that, as of the date the test rate of interest for the debt instrument is determined, the Federal short-term rate is 8 percent, compounded annually. Assume further that, as a result of the interest rate cap of 8.5 percent, compounded annually, the expected yield of the debt instrument is significantly less than the expected yield of the debt instrument if it did not include the interest rate cap. Under paragraph (f)(1)(ii) of this section, the variable payments are treated as contingent payments for purposes of this section.

(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.

[T.D. 8517, 59 FR 4821, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30141, June 14, 1996]

§ 1.1274–3 Potentially abusive situations defined.

(a) *In general.* For purposes of section 1274, a potentially abusive situation means—

(1) A tax shelter (as defined in section 6662(d)(2)(C)(ii)); or

(2) Any other situation involving—

(i) A recent sales transaction;

(ii) Nonrecourse financing;

(iii) Financing with a term in excess of the useful life of the property; or

(iv) A debt instrument with clearly excessive interest.