

(b) *Operating rules*—(1) *Debt instrument exchanged for nonrecourse financing.* Nonrecourse financing does not include an exchange of a nonrecourse debt instrument for an outstanding recourse or nonrecourse debt instrument.

(2) *Nonrecourse debt with substantial down payment.* Nonrecourse financing does not include a sale or exchange of a real property interest financed by a nonrecourse debt instrument if, in addition to the nonrecourse debt instrument, the purchaser makes a down payment in money that equals or exceeds 20 percent of the total stated purchase price of the real property interest. For purposes of the preceding sentence, a real property interest means any interest, other than an interest solely as a creditor, in real property.

(3) *Clearly excessive interest.* Interest on a debt instrument is clearly excessive if the interest, in light of the terms of the debt instrument and the creditworthiness of the borrower, is clearly greater than the arm's length amount of interest that would have been charged in a cash lending transaction between the same two parties.

(c) *Other situations to be specified by Commissioner.* The Commissioner may designate in the Internal Revenue Bulletin situations that, although described in paragraph (a)(2) of this section, will not be treated as potentially abusive because they do not have the effect of significantly misstating basis or amount realized (see § 601.601(d)(2)(ii) of this chapter).

(d) *Consistency rule.* The issuer's determination that the debt instrument is or is not issued in a potentially abusive situation is binding on all holders of the debt instrument. However, the issuer's determination is not binding on a holder who explicitly discloses a position that is inconsistent with 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.

[T.D. 8517, 59 FR 4822, Feb. 2, 1994]

§ 1.1274-4 Test rate.

(a) *Determination of test rate of interest*—(1) *In general*—(i) *Test rate is the 3-month rate.* Except as provided in paragraph (a)(2) of this section, the test rate of interest for a debt instrument issued in consideration for the sale or exchange of property is the 3-month rate.

(ii) *The 3-month rate.* Except as provided in paragraph (a)(1)(iii) of this section, the 3-month rate is the lower of—

(A) The lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the first month in 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 lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

(iii) *Special rule if there is no binding written contract.* If there is no binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated, the 3-month rate is the lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

(2) *Test rate for certain debt instruments*—(i) *Sale-leaseback transactions.*

Under section 1274(e) (relating to certain sale-leaseback transactions), the test rate is 110 percent of the 3-month rate determined under paragraph (a)(1) of this section. For purposes of section 1274(e)(3), related party means a person related to the transferor within the meaning of section 267(b) or 707(b)(1).

(ii) *Qualified debt instrument.* Under section 1274A(a), the test rate for a qualified debt instrument is no greater than 9 percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.

(iii) *Alternative test rate for short-term obligations*—(A) *Requirements.* This paragraph (a)(2)(iii)(A) provides an alternative test rate under section 1274(d)(1)(D) for a debt instrument with

a maturity of 1 year or less. This alternative test rate applies, however, only if the debt instrument provides for adequate stated interest using the alternative test rate, the issuer provides on the face of the debt instrument that the instrument qualifies as having adequate stated interest under section 1274(d)(1)(D), and the issuer and holder treat or agree to treat the instrument as having adequate stated interest.

(B) *Alternative test rate.* For purposes of paragraph (a)(2)(iii)(A), the alternative test rate is the market yield on U.S. Treasury bills with the same maturity date as the debt instrument. If the same maturity date is not available, the market yield on U.S. Treasury bills that mature in the same week or month as the debt instrument is used. The alternative test rate is determined as of the 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 as of the date of the sale or exchange, whichever date results in a lower rate. If there is no binding written contract, however, the alternative test rate is determined as of the date of the sale or exchange.

(b) *Applicable Federal rate.* Except as otherwise provided in this section, the applicable Federal rate for a debt instrument is based on the term of the instrument (i.e., short-term, mid-term, or long-term). See section 1274(d)(1). The Internal Revenue Service publishes the applicable Federal rates for each month in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter). The applicable Federal rates are based on the yield to maturity of outstanding marketable obligations of the United States of similar maturities during the one month period ending on the 14th day of the month preceding the month for which the rates are applicable.

(c) *Special rules to determine the term of a debt instrument for purposes of determining the applicable Federal rate—(1) Installment obligation.* If a debt instrument is an installment obligation (as defined in §1.1273-1(e)(1)), the term of the instrument is the instrument's weighted average maturity (as defined in §1.1273-1(e)(3)).

(2) *Certain variable rate debt instruments—(i) In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, if a variable rate debt instrument (as defined in §1.1275-5(a)) provides for stated interest at a qualified floating rate (or rates), the term of the instrument is determined by reference to the longest interval between interest adjustment dates, or, if the variable rate debt instrument provides for a fixed rate, the interval between the issue date and the last day on which the fixed rate applies, if this interval is longer.

(ii) *Restrictions on adjustments.* If, due to significant restrictions on variations in a qualified floating rate or the use of certain formulae pursuant to §1.1275-5(b)(2) (e.g., 15 percent of 1-year LIBOR, plus 800 basis points), the rate in substance resembles a fixed rate, the applicable Federal rate is determined by reference to the term of the debt instrument.

(3) *Counting of either the issue date or the maturity date.* The term of a debt instrument includes either the issue date or the maturity date, but not both dates.

(4) *Certain debt instruments that provide for principal payments uncertain as to time.* If a debt instrument provides for principal payments that are fixed in total amount but uncertain as to time, the term of the instrument is determined by reference to the latest possible date on which a principal payment can be made or, in the case of an installment obligation, by reference to the longest weighted average maturity under any possible payment schedule.

(d) *Foreign currency loans.* If all of the payments of a debt instrument are denominated in, or determined by reference to, a currency other than the U.S. dollar, the applicable Federal rate for the debt instrument is a foreign currency rate of interest that is analogous to the applicable Federal rate described in this section. For this purpose, an analogous rate of interest is a rate based on yields (with the appropriate compounding period) of the highest grade of outstanding marketable obligations denominated in such currency (excluding any obligations that benefit from special tax exemptions or preferential tax rates not

available to debt instruments generally) with due consideration given to the maturities of the obligations.

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

*Example 1.* Variable rate debt instrument that limits the amount of increase and decrease in the rate—(i) *Facts.* On July 1, 1996, A sells nonpublicly traded property to B in return for a 5-year debt instrument that provides for interest to be paid on July 1 of each year, beginning on July 1, 1997, based on the prime rate of a local bank on that date. However, the interest rate cannot increase or decrease from one year to the next by more than .25 percentage points (25 basis points).

(ii) *Significant restriction.* The debt instrument is a variable rate debt instrument (as defined in § 1.1275-5) that provides for stated interest at a qualified floating rate. Assume that based on all the facts and circumstances, the restriction is a significant restriction on the variations in the rate of interest. Under paragraph (c)(2)(ii) of this section, the applicable Federal rate is determined by reference to the term of the debt instrument, and the applicable Federal rate is the Federal mid-term rate.

*Example 2. Installment obligation—(i) Facts.* On January 1, 1996, A sells nonpublicly traded property to B in exchange for a debt instrument that calls for a payment of \$500,000 on January 1, 2001, and a payment of \$1,000,000 on January 1, 2006. The debt instrument does not provide for any stated interest.

(ii) *Determination of term.* The debt instrument is an installment obligation. Under paragraph (c)(1) of this section, the term of the debt instrument is its weighted average maturity (as defined in § 1.1273-1(e)(3)). The debt instrument's weighted average maturity is 8.33 years, which is the sum of (A) the ratio of the first payment to total payments (500,000/1,500,000), multiplied by the number of complete years from the issue date until the payment is due (5 years), and (B) the ratio of the second payment to total payments (1,000,000/1,500,000), multiplied by the number of complete years from the issue date until the second payment is due (10 years).

(iii) *Applicable Federal rate.* Based on the calculation in paragraph (ii) of this example, the term of the debt instrument is treated as 8.33 years. Consequently, the applicable Federal rate is the Federal mid-term rate.

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#### § 1.1274-5 Assumptions.

(a) *In general.* Section 1274 does not apply to a debt instrument if the debt instrument is assumed, or property is taken subject to the debt instrument,

in connection with a sale or exchange of property, unless the terms of the debt instrument, as part of the sale or exchange, are modified in a manner that would constitute an exchange under section 1001.

(b) *Modifications of debt instruments—*(1) *In general.* Except as provided in paragraph (b)(2) of this section, if a debt instrument is assumed, or property is taken subject to a debt instrument, in connection with a sale or exchange of property, the terms of the debt instrument are modified as part of the sale or exchange, and the modification triggers an exchange under section 1001, the modification is treated as a separate transaction taking place immediately before the sale or exchange and is attributed to the seller of the property. For purposes of this paragraph (b), a debt instrument is not considered to be modified as part of the sale or exchange unless the seller knew or had reason to know about the modification.

(2) *Election to treat buyer as modifying the debt instrument—(i) In general.* Rather than having the rules in paragraph (b)(1) of this section apply, the seller and buyer may jointly elect to treat the transaction as one in which the buyer first assumed the original (unmodified) debt instrument and then subsequently modified the debt instrument. For this purpose, the modification is treated as a separate transaction taking place immediately after the sale or exchange.

(ii) *Time and manner of making the election.* The buyer and seller make the election under paragraph (b)(2)(i) of this section by jointly signing a statement that includes the names, addresses, and taxpayer identification numbers of the seller and buyer, and a clear indication that the election is being made under paragraph (b)(2)(i) of this section. Both the buyer and the seller must sign this statement not later than the earlier of the last day (including extensions) for filing the Federal income tax return of the buyer or seller for the taxable year in which the sale or exchange of the property occurs. The buyer and seller should attach this signed statement (or a copy thereof) to their timely filed Federal income tax returns.