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

Example 1. Contract that does not have adequate stated interest. On January 1, 1995, A sells B nonpublicly traded property under a contract that calls for a $100,000 payment of principal on January 1, 2005, and 10 annual interest payments of $9,000 on January 1 of each year, beginning on January 1, 1996. Assume that the test rate of interest is 9.2 percent, compounded annually. The contract does not provide for adequate stated interest because it does not provide for interest equal to 9.2 percent, compounded annually. The present value of the deferred payments is $98,727.69. As a result, the contract has unstated interest of $1,272.31 ($100,000 − $98,727.69).

Example 2. Contract that does not have adequate stated interest; no interest for initial short period. On May 1, 1996, A sells B nonpublicly traded property under a contract that calls for B to make a principal payment of $200,000 on December 31, 1998, and semiannual interest payments of $9,000, payable on June 30 and December 31 of each year, beginning on December 31, 1996. Assume that the test rate of interest is 9 percent, compounded semiannually. Even though the contract calls for a stated rate of interest no lower than the test rate of interest, the contract does not provide for adequate stated interest because the stated rate of interest does not apply for the short period from May 1, 1996, through June 30, 1996.

Example 3. Potentially abusive situation—(i) *Facts.* In a potentially abusive situation, a contract for the sale of nonpublicly traded personal property calls for the issuance of a cash method debt instrument (as defined in section 1274A(c)(2)) with a stated principal amount of $700,000, payable in 5 years. No other consideration is given. The debt instrument calls for annual payments of interest over its entire term at a rate of 9.2 percent, compounded annually (the test rate of interest applicable to the debt instrument). Thus, the present value of the deferred payment and the interest payments is $700,000. Assume that the fair market value of the property is $500,000.

(ii) *Amount of unstated interest.* A cash method debt instrument received in exchange for property in a potentially abusive situation provides for adequate stated interest only if the sum of the deferred payments under the instrument does not exceed the fair market value of the property. Because the deferred payment ($700,000) exceeds the fair market value of the property ($500,000), the debt instrument does not provide for adequate stated interest. Therefore, the debt instrument has unstated interest of $200,000.

Example 4. Variable rate debt instrument with adequate stated interest; variable rate as of the issue date greater than the test rate— (i) *Facts.* A contract for the sale of nonpublicly traded property calls for the issuance of a debt instrument in the principal amount of $75,000 due in 10 years. The debt instrument calls for interest payable semiannually at a rate of 3 percentage points above the yield on 6-month Treasury bills at the mid-point of the semiannual period immediately preceding each interest payment date. Assume that the interest rate is a qualified floating rate and that the debt instrument is a variable rate debt instrument within the meaning of §1.1275–5.

(ii) *Adequate stated interest.* Under paragraph (b)(1) of this section, rules similar to those in §1.1274–2(f) apply to determine whether the debt instrument has adequate stated interest. Assume that the test rate of interest applicable to the debt instrument is 9 percent, compounded semiannually. Assume also that the yield on 6-month Treasury bills on the date of the sale is 8.89 percent, which is greater than the yield on 6-month Treasury bills on the first date on which there is a binding written contract that substantially sets forth the terms under which the sale is consummated. Under §1.1274–2(f), the debt instrument is tested for adequate stated interest as if it provided for a stated rate of interest of 11.89 percent (3 percent plus 8.89 percent), compounded semiannually, payable over its entire term. Because the test rate of interest is 9 percent, compounded semiannually, and the debt instrument is treated as providing for stated interest of 11.89 percent, compounded semiannually, the debt instrument provides for adequate stated interest.

(d) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4806, Feb. 2, 1994]

§ 1.483–3 Test rate of interest applicable to a contract.

(a) *General rule.* For purposes of section 483, the test rate of interest for a contract is the same as the test rate that would apply under §1.1274–4 if the contract were a debt instrument. Paragraph (b) of this section, however, provides for a lower test rate in the case of certain sales or exchanges of land between related individuals.

(b) *Lower rate for certain sales or exchanges of land between related individuals*—(1) *Test rate.* In the case of a qualified sale or exchange of land between related individuals (described in section 483(e)), the test rate is not greater than 6 percent, compounded semiannually, or an equivalent rate based on an appropriate compounding period.

(2) *Special rules.* The following rules and definitions apply in determining whether a sale or exchange is a qualified sale under section 483(e):

(i) *Definition of family members.* The members of an individual's family are determined as of the date of the sale or exchange. The members of an individual's family include those individuals described in section 267(c)(4) and the spouses of those individuals. In addition, for purposes of section 267(c)(4), full effect is given to a legal adoption, ancestor means parents and grandparents, and lineal descendants means children and grandchildren.

(ii) *$500,000 limitation.* Section 483(e) does not apply to the extent that the stated principal amount of the debt instrument issued in the sale or exchange, when added to the aggregate stated principal amount of any other debt instruments to which section 483(e) applies that were issued in prior qualified sales between the same two individuals during the same calendar year, exceeds $500,000. See *Example 3* of paragraph (b)(3) of this section.

(iii) *Other limitations.* Section 483(e) does not apply if the parties to a contract include persons other than the related individuals and the parties enter into the contract with an intent to circumvent the purposes of section 483(e). In addition, if the property sold or exchanged includes any property other than land, section 483(e) applies only to the extent that the stated principal amount of the debt instrument issued in the sale or exchange is attributable to the land (based on the relative fair market values of the land and the other property).

(3) *Examples.* The following examples illustrate the rules of this paragraph (b).

Example 1. On January 1, 1995, A sells land to B, A's child, for $650,000. The contract for sale calls for B to make a $250,000 down payment and issue a debt instrument with a stated principal amount of $400,000. Because the stated principal amount of the debt instrument is less than $500,000, the sale is a qualified sale and section 483(e) applies to the debt instrument.

Example 2. The facts are the same as in *Example 1* of paragraph (b)(3) of this section, except that on June 1, 1995, A sells additional land to B under a contract that calls for B to issue a debt instrument with a stated principal amount of $100,000. The stated principal amount of this debt instrument ($100,000) when added to the stated principal amount of the prior debt instrument ($400,000) does not exceed $500,000. Thus, section 483(e) applies to both debt instruments.

Example 3. The facts are the same as in *Example 1* of paragraph (b)(3) of this section, except that on June 1, 1995, A sells additional land to B under a contract that calls for B to issue a debt instrument with a stated principal amount of $150,000. The stated principal amount of this debt instrument when added to the stated principal amount of the prior debt instrument ($400,000) exceeds $500,000. Thus, for purposes of section 483(e), the debt instrument issued in the sale of June 1, 1995, is treated as two separate debt instruments: a $100,000 debt instrument (to which section 483(e) applies) and a $50,000 debt instrument (to which section 1274, if otherwise applicable, applies).

(c) *Effective date.* This section applies to sales and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for sales and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4807, Feb. 2, 1994]

§ 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,