

(3) *Example.* The following example illustrates the rule of paragraph (m) of this section.

*Example:* (i) *Facts.* On January 15, 1995, A purchases at original issue, for \$1,005, B corporation's debt instrument. The debt instrument provides for a payment of principal of \$1,000 on January 1, 2005, and provides for semiannual interest payments of \$60 on January 1 and July 1 of each year, beginning on July 1, 1995.

(ii) *Determination of pre-issuance accrued interest.* Under paragraphs (m)(1) and (m)(2) of this section, \$5 of the \$1,005 initial purchase price of the debt instrument is allocable to pre-issuance accrued interest. Accordingly, the debt instrument's issue price may be computed by subtracting the amount of pre-issuance accrued interest (\$5) from the issue price otherwise computed under this section (\$1,005), resulting in an issue price of \$1,000. If the issue price is computed in this manner, \$5 of the \$60 payment made on July 1, 1995, must be treated as a repayment by B of the pre-issuance accrued interest.

[T.D. 8517, 59 FR 4817, Feb. 2, 1994]

**§ 1.1274-1 Debt instruments to which section 1274 applies.**

(a) *In general.* Subject to the exceptions and limitations in paragraph (b) of this section, section 1274 and this section apply to any debt instrument issued in consideration for the sale or exchange of property. For purposes of section 1274, property includes debt instruments and investment units, but does not include money, services, or the right to use property. For the treatment of certain obligations given in exchange for services or the use of property, see sections 404 and 467. For purposes of this paragraph (a), money includes functional currency and, in certain circumstances, nonfunctional currency. See § 1.988-2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.

(b) *Exceptions—(1) Debt instrument with adequate stated interest and no OID.* Section 1274 does not apply to a debt instrument if—

(i) All interest payable on the instrument is qualified stated interest;

(ii) The stated rate of interest is at least equal to the test rate of interest (as defined in § 1.1274-4);

(iii) The debt instrument is not issued in a potentially abusive situation (as defined in § 1.1274-3); and

(iv) No payment from the buyer-borrower to the seller-lender designated as points or interest is made at the time of issuance of the debt instrument.

(2) *Exceptions under sections 1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1)—(i) In general.* Sections 1274(c)(1)(B), 1274(c)(3), 1274A(c), and 1275(b)(1) describe certain transactions to which section 1274 does not apply. This paragraph (b)(2) provides certain rules to be used in applying those exceptions.

(ii) *Special rules for certain exceptions under section 1274(c)(3)—(A) Determination of sales price for certain sales of farms.* For purposes of section 1274(c)(3)(A), the determination as to whether the sales price cannot exceed \$1,000,000 is made without regard to any other exception to, or limitation on, the applicability of section 1274 (e.g., without regard to the special rules regarding sales of principal residences and land transfers between related persons). In addition, the sales price is determined without regard to section 1274 and without regard to any stated interest. The sales price includes the amount of any liability included in the amount realized from the sale or exchange. See § 1.1001-2.

(B) *Sales involving total payments of \$250,000 or less.* Under section 1274(c)(3)(C), the determination of the amount of payments due under all debt instruments and the amount of other consideration to be received is made as of the date of the sale or exchange or, if earlier, the contract date. If the precise amount due under any debt instrument or the precise amount of any other consideration to be received cannot be determined as of that date, section 1274(c)(3)(C) applies only if it can be determined that the maximum of the aggregate amount of payments due under the debt instruments and other consideration to be received cannot exceed \$250,000. For purposes of section 1274(c)(3)(C), if a liability is assumed or property is taken subject to a liability, the aggregate amount of payments due includes the outstanding principal balance or adjusted issue price (in the case of an obligation originally issued at a discount) of the obligation.

(C) *Coordination with section 1273 and § 1.1273-2.* In accordance with section

1274(c)(3)(D), section 1274 and this section do not apply if the issue price of a debt instrument issued in consideration for the sale or exchange of property is determined under paragraph (a)(1), (b)(1), or (c)(1) of § 1.1273-2.

(3) *Other exceptions to section 1274*—(i) *Holders of certain below-market instruments.* Section 1274 does not apply to any holder of a debt instrument that is issued in consideration for the sale or exchange of personal use property (within the meaning of section 1275(b)(3)) in the hands of the issuer and that evidences a below-market loan described in section 7872(c)(1).

(ii) *Transactions involving certain demand loans.* Section 1274 does not apply 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 semi-annually. 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.