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.


§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.

(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.

(4) Debt-for-debt exchange—(1) Rule. A debt instrument issued in a debt-for-debt exchange, including a deemed exchange under §1.1001-3, will not be treated as the subject of a recent sales transaction for purposes of section 1274(b)(3)(B)(ii)(I) even if the debt instrument exchanged for the newly issued debt instrument was recently acquired prior to the exchange. Therefore, the issue price of the debt instrument will not be determined under section 1274(b)(3). However, if the debt instrument or the property for which the debt instrument is issued is publicly traded within the meaning of §1.1273-
(f), the rules of §1.1273–2 will apply to
determine the issue price of the debt
instrument.

(ii) Effective/applicability date. Para-
graph (b)(4)(i) of this section applies to
a debt instrument issued on or after
November 13, 2012.

(c) Other situations to be specified by
Commissioner. The Commissioner may
designate in the Internal Revenue Bul-
letin situations that, although de-
scribed in paragraph (a)(2) of this sec-
tion, 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 de-
termination that the debt instrument
is or is not issued in a potentially abu-
sive 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 other-
wise prescribed by the Commissioner,
the disclosure must be made on a state-
ment attached to the holder’s timely
filed Federal income tax return for the
taxable year that includes the acquisi-
tion 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, as amend-

§ 1.1274–4 Test rate.

(a) Determination of test rate of inter-
est—(1) In general—(i) Test rate is the 3-
month rate. Except as provided in para-
graph (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 pro-
vided in paragraph (a)(1)(iii) of this sec-
tion, 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 con-
summated; 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 con-
summated, the 3-month rate is the low-
est applicable Federal rate (based on
the appropriate compounding period)
effect during the 3-month period
ending with the month in which the
sale or exchange occurs.

(2) Test rate for certain debt instru-
ments—(i) Sale-leaseback transactions.
Under section 1274(e) (relating to cer-
tain 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 semiannu-
ally, or an equivalent rate based on an
appropriate compounding period.

(iii) Alternative test rate for short-term
obligations—(A) Requirements. This
paragraph (a)(2)(ii)(A) provides an al-
ternative test rate under section
1274(d)(1)(D) for a debt instrument with
a maturity of 1 year or less. This alter-
native test rate applies, however, only
if the debt instrument provides for ade-
quate stated interest using the alter-
native test rate, the issuer provides on
the face of the debt instrument that
the instrument qualifies as having ade-
quate 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)(ii)(A), the alter-
native test rate is the market yield on
U.S. Treasury bills with the same ma-
turity date as the debt instrument. If
the same maturity date is not avail-
able, the market yield on U.S. Treas-
ury bills that mature in the same week
or month as the debt instrument is