Internal Revenue Service, Treasury

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 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)(ii) 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 for interest equal to 12.5 percent, compounded monthly. Because the test rate of interest applicable to the debt instrument is determined, the Federal test rate of interest is 10.5 percent, compounded monthly. Assume that, as of the date the test rate of interest for the debt instrument is determined, the Federal test rate of interest is 12.5 percent, compounded monthly. Assume further that, as a result of the test rate of interest applicable to the debt instrument, the effective 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.

§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
§ 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.

(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.

(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.

(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.