

# REAL ESTATE TAXATION

## A Practitioner's Guide

Third Edition

### Chapter 3 Financing Real Estate

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## Chapter 3

# Financing Real Estate

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### ¶ 300 OVERVIEW OF CHAPTER

Financing the acquisition of real estate often involves third parties who are willing to lend money at interest based on the security afforded by the real estate. This financing is in addition to the equity financing in the form of money, property or services contributed to a partnership or corporation by its principals or the “down payment” made by an individual purchaser of real estate.

In most cases, the security for the real estate loan takes the form of a mortgage under which the borrower retains title to the property but gives the lender the right to take the property (foreclose) if the borrower fails to live up to the loan agreement. In some cases, however, financing real estate may involve the actual transfer of title to the “lender,” who purchases the property but leases the property back to the “borrower” in a sale-leaseback transaction. Other leasing arrangements also may serve as financing devices.

Although seller financing is touched upon in this chapter, particularly in regard to the original issue discount and deferred payment sale rules of the tax code, installment sales and seller-financed transactions are explored further in Chapter 14. Also, interest on mortgages on taxpayers’ personal residences is a topic covered in Chapter 17, along with other deductions for homeowners.

### ¶ 301 MORTGAGE FINANCING

As discussed at ¶ 101, the original cost basis of property includes the amount of any mortgage given to secure payment of any portion of the purchase price of the property. Similarly, the amount realized on the sale of property includes the amount of any mortgage that the seller is relieved of on the sale. If a mortgage is placed on previously owned property or an existing mortgage is refinanced, basis is not affected, nor does the owner realize taxable income from the proceeds of the loan. This rule applies even if the new mortgage exceeds the owner’s adjusted basis in the property. Refinancing a previously owned property, therefore, is frequently a tax-free source of cash, but there is, of course, the obligation to repay the debt.

While mortgage financing is a popular way to finance real estate, it does entail certain costs for both the borrower and the lender, and these costs have tax consequences. Also, when a mortgage is satisfied at other than face amount, there may be tax consequences. These tax ramifications of mortgage financing are discussed in the following paragraphs. Gifts of mortgaged property are considered at ¶ 1615, and the sale of mortgaged property is discussed at ¶ 1303.

### ¶ 303 Mortgage Costs

Both the borrower (mortgagor) and the lender (mortgagee) are likely to incur various costs in connection with a mortgage loan. These costs may include legal fees, finders' or placement fees, brokers' commissions, appraisal costs, and the costs of surveys and title investigation.

#### ¶ 303.1 Borrower's Costs

Fees, commissions, and other expenses paid by the borrower to obtain a mortgage or other loan on the property are not part of the cost of the property. Rather, they are more like capital expenditures that have a life that extends over the term of the loan. If business or income-producing property is involved, these costs may be amortized over the life of the loan and deducted accordingly.<sup>1</sup> Commissions paid to secure renewal of a loan also are subject to amortization.<sup>2</sup>

(For the treatment of the costs of obtaining a loan on a personal residence or other property that is held for personal rather than business or investment purposes, including the treatment of points, see ¶ 1703 and 1705.)

The term of the loan as specified in the loan agreement generally governs the period over which the borrower amortizes the costs, even if prepayment in full is allowed at any time. Amortization deductions for loan costs are taken on a straight-line basis. For instance, if a purchaser incurred \$5,000 in costs in connection with a loan for the acquisition of business property and the term of the loan were 20 years, the purchaser would deduct \$250 each year for 20 years. This would be the case regardless of whether the purchaser used the cash or accrual method of accounting.<sup>3</sup>

There are no rulings or case law actually on point governing the treatment of mortgage acquisition costs if the purchaser actually makes a partial prepayment on a loan for which the purchaser is amortizing costs. Presumably, if the prepayment merely shortens the

<sup>1</sup> Rev. Rul. 70-360, 1970-2 CB 103; *Detroit Consolidated Theatres, Inc.*, CA-6, 43-1 USTC ¶ 9222, 133 F.2d 200.

<sup>2</sup> S. Spitzer, 23 BTA 776, CCH Dec. 7038.

<sup>3</sup> *J.S. Lovejoy*, 18 BTA 1179, CCH Dec. 5830.

term remaining on the loan, the purchaser may refigure the amortization deductions to spread any unamortized costs out over the shorter period remaining on the loan.

If prepayment of the unpaid balance of a loan is made in full at any time, any unamortized costs of obtaining the loan are deductible at that time.<sup>4</sup> The same rule applies whenever the property is sold or disposed of before the costs are fully amortized. A taxpayer deducts the balance of unamortized loan costs when the liability for the loan and the property securing the loan are transferred.<sup>5</sup>

In the case of a corporation, any unamortized mortgage or loan costs are deductible in full in the year the corporation distributes assets to its shareholders in liquidation of the corporation.<sup>6</sup>

In the case of an individual, the balance of unamortized loan costs may be deducted on the income tax return for the year of the individual's death. Although the expenses incurred to obtain a loan are in the nature of capital expenditures that normally must be amortized over the term of the loan, the individual's death terminates the use of the loan proceeds, and the IRS has ruled that it is appropriate to deduct the balance of the unamortized loan costs on the deceased individual's final return.<sup>7</sup>

### ¶ 303.2 Lender's Costs

Generally, a lender who regularly engages in the business of making loans is entitled to deduct most costs associated with the making of the loans as ordinary and necessary business expenses under Code Sec. 162. The costs falling into this ordinary and necessary category would include most overhead costs. The IRS has ruled, however, that finders' fees and buying commissions paid by banks, building and loan associations, other classes of banks and financial institutions to brokers, title companies, and others for their introduction of an acceptable applicant for a mortgage loan are part of the acquisition cost of the loan, which must be capitalized and amortized over the term of the mortgage loan.<sup>8</sup> Capitalization and amortization also seems to be the rule for the occasional lender, that is, the lender who is not regularly engaged in the business of lending money and who, therefore, has no expenses falling into the ordinary and necessary category.

<sup>4</sup> *S&L Building Corp.*, 19 BTA 788, CCH Dec. 6019, Acq. X-1 CB 60, rev'd CA-2, 1932 CCH ¶ 9422, 60 F.2d 719, rev'd S. Ct. 3 USTC ¶ 1064, 288 U.S. 406.

<sup>5</sup> See *S&L Building Corp.* above; see also *O.C. Wacker*, 40 TCM 1009, CCH Dec. 37,166(M), T.C. Memo. 1980-324.

<sup>6</sup> *Longview Hilton Hotel Co.*, 9 TC 180, CCH Dec. 15,962, Acq. 1947-2 CB 3; *Anover Realty Corp.*, 33 TC 671, CCH Dec. 24,006.

<sup>7</sup> Rev. Rul. 86-67, 1986-1 CB 238.

<sup>8</sup> Rev. Rul. 57-400, 1957-2 CB 520.

**¶ 305 Buy Downs and Similar Arrangements**

In order to move homes out of inventory in times of high interest rates, builders may make it easier for purchasers to meet monthly mortgage payments by buying down or otherwise subsidizing the mortgage payments. For instance, the builder may work out an arrangement with a financial institution under which the institution will charge a lower rate of interest to purchasers of the builder's homes in exchange for up-front payments by the builder. Such an arrangement reduces a purchaser's debt service and makes it easier for a purchaser to buy a home, thus increasing the builder's sales. These payments by the builder should be considered an ordinary and necessary expense in order to sell homes, and, therefore, should be deductible by the builder. Alternatively, the payments might be considered a reduction of the sales price, which would have the same practical effect as the deduction.

In a Letter Ruling,<sup>9</sup> the IRS did rule that a builder who purchased loans from a financial institution which made below market-rate loans to purchasers of the builder's homes was entitled to deduct the excess of the purchase price paid for the loans over the fair market value of the loans. In this case, the builder was regularly engaged in the business of building and selling homes, and the premium paid by the builder for the loans was an expense incurred to permit the builder to sell his products. This ruling supports the idea that costs incurred by a builder to subsidize customers' mortgage payments, whatever the actual arrangement, are deductible ordinary and necessary business expenses.

**¶ 307 Payoff of Mortgage**

Just as the receipt of the proceeds of a mortgage produces no tax consequences, the repayment of the amount borrowed also has no tax consequences. Sometimes, lenders charge a premium, a "prepayment penalty," for the privilege of retiring a mortgage debt before the end of the loan term. In other cases, the lender may discount the mortgage debt for early payment. In either case, tax consequences flow from the satisfaction of a mortgage debt at other than its face amount.

**¶ 307.1 Prepayment Penalties**

A mortgagor who pays a penalty to the mortgagee for the privilege of prepaying a mortgage debt treats the prepayment penalty as additional interest.<sup>10</sup> When Rev. Rul. 57-198 was issued, of course, interest was deductible regardless of the nature of the underlying debt. Today, the interest deduction is subject to various limits based on the nature of the debt, although interest on property used in a trade or business is

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<sup>9</sup> IRS Letter Ruling 8229120, April 23, 1982.

<sup>10</sup> Rev. Rul. 57-198, 1957-1 CB 94.

deductible in full. Presumably, a prepayment penalty treated as interest is subject to the same limitations.

In *12701 Shaker Blvd. Co.*,<sup>11</sup> a taxpayer attempted to amortize, as a mortgage cost, a prepayment penalty paid to one lender over the life of a new mortgage obtained from a different lender. Since the penalty was paid to extinguish an existing debt in a transaction that was independent of the new financing and was not part of the cost of the new financing, it had to be deducted in the year in which it was paid.

On the other hand, the purchaser of an apartment building could not deduct currently a subordination fee paid to refinance existing loans on the property purchased. The fee in this case was distinguished from the prepayment penalty in *12701 Shaker Blvd.* because the fee was not paid to extinguish an already existing debt, but was paid to obtain refinancing of the existing first and second mortgages.<sup>12</sup>

The mortgagee who receives a prepayment penalty treats the penalty as additional interest income. The prepayment penalty is an additional charge which the borrower pays for the privilege of using the mortgage money for a shorter period than originally agreed.<sup>13</sup> This is the rule regardless of whether the prepayment penalty is provided for in the loan agreement or is separately negotiated.<sup>14</sup>

### ¶ 307.2 *Payment Discounts*

The reduction of a purchase-money mortgage for a solvent debtor is treated as a reduction or adjustment in the purchase price, rather than as the discharge of a debt.<sup>15</sup> Accordingly, the debtor realizes no income, and the debtor's basis for the property is reduced to reflect the reduced purchase price. For the seller-lender, the debt reduction also is an adjustment to the sale price. This rule applies only to adjustments to purchase-money debts between original purchasers and sellers. It does not apply to purchase-money debts held or transferred to third parties or to mortgages held by other than the seller of the property, nor does it apply if the purchaser of the property has transferred the property to someone else.

Congress enacted the rule of Code Sec. 108(e)(5) to resolve the problem of whether an adjustment to a purchase-money obligation was an adjustment to the purchase price or income from the discharge of indebtedness. Congress has also enacted special statutory rules governing insolvent and bankrupt debtors and the discharge of qualified

<sup>11</sup> 36 TC 255, CCH Dec. 24,825, aff'd CA-6, 63-1 USTC ¶ 9194, 312 F.2d 749.

<sup>12</sup> IRS Letter Ruling 8614002, September 30, 1985.

<sup>13</sup> *General American Life Insurance Co.*, 25 TC 1265, CCH Dec. 21,631, Acq. 1956-2 CB 5.

<sup>14</sup> *S.R. Lewis*, 65 TC 625, CCH Dec. 33,563.

<sup>15</sup> Code Sec. 108(e)(5).

real property business indebtedness, and these are considered beginning at ¶ 1201 in Chapter 12, in which issues relating to troubled financings are discussed. Unfortunately, the enactment of Code Sec. 108(e)(5) did not resolve whether a discount applied to a mortgage debt is income or an adjustment to purchase price in other situations. For this, we must rely on a hodgepodge of case law that attempts to distinguish between price reductions and income from the discharge of indebtedness.

Generally, a taxpayer realizes income on the nongratuitous discharge of indebtedness to the extent the debt is cancelled or forgiven.<sup>16</sup> In Rev. Rul. 82-202,<sup>17</sup> the IRS ruled that an individual taxpayer realizes discharge of indebtedness income under Code Sec. 61(a)(12) on the discounted prepayment to a lender of all or a portion of mortgage debt. The amount of the discount is includible in income whether the mortgage note is recourse or nonrecourse. This would seem to be the rule whenever a mortgage debt is satisfied (other than in a gift situation) at less than face value and the fair market value of the property is more than the mortgage debt.<sup>18</sup> In Rev. Rul. 91-31,<sup>19</sup> the IRS amplified Rev. Rul. 82-202 so that it applies whether the fair market value of the property is greater or less than the principal balance of the mortgage.

There is, however, a line of cases that holds that when a buyer purchases property subject to a mortgage, or executes a mortgage as security for the unpaid portion of the purchase price or assumes an existing mortgage, and later satisfies the mortgage for less than the face amount of the mortgage but for more than the fair market value of the property at the time the mortgage is satisfied, the buyer does not recognize income. Rather, in such a case, the reduction in the mortgage debt is treated as an adjustment to the cost basis of the property.<sup>20</sup>

In *Hirsch*, a taxpayer purchased real estate for \$10,000 cash and a \$19,000 mortgage, which was reduced to \$15,000. When the mortgage matured, the property was worth only \$8,000, and the mortgagee accepted \$8,000 in discharge of the debt. This was held to be an adjustment of the purchase price, and the solvent mortgagor realized no income from the discharge of the mortgage at a discount. In *Fifth Ave.-14th Street Corp.*,<sup>21</sup> however, the court expressed the opinion that the rule applied in *Hirsch* and a series of cases that followed it would be "limited to a case of a purchase money obligation where the vendor-mortgagee, in negotiations directly relating to the purchase price, agrees to a reduction; it has not been applied where the reduction

<sup>16</sup> Code Sec. 61(a)(12).

<sup>17</sup> 1982-2 CB 35.

<sup>18</sup> See *J.A. Michaels*, 87 TC 1412, CCH Dec. 43,555; *W. DiLaura*, 53 TCM 1077, CCH Dec. 43,973(M), T.C. Memo. 1987-291; *J.H. Sutphin*, Cls. Ct., 88-1 USTC ¶ 9269, 14 Cls. Ct. 545.

<sup>19</sup> 1991-1 CB 19.

<sup>20</sup> See, for example, *K. Hirsch*, CA-7, 40-2 USTC ¶ 9791, 115 F.2d 656.

<sup>21</sup> CA-2, 45-1 USTC ¶ 9115, 147 F.2d 453.

results from an arm's-length transaction relating solely to the debt itself, or from a purchase of the taxpayer's obligations at less than par in the market."

### ¶ 311 AT-RISK RULES

At one time, an investor could purchase an asset and take deductions for "tax losses" generated by the investment up to the full amount of the cost or other basis, even if the basis included borrowed amounts that the investor might never have to repay. With this as the rule, tax-shelter investments that were marketed primarily for their possible tax benefits proliferated. The main feature of many of these investments was the use of nonrecourse financing to provide investors with a high basis that could support large deductions, deductions that would exceed many times over any amount the investor might actually lose on the investment. (In a nonrecourse loan, the lender can look only to the asset financed by the loan for repayment, and the borrower is not personally liable for repayment of the borrowed amounts.)

Congress responded to the abuses in the use of nonrecourse financing by enacting "at-risk" rules in the Tax Reform Act of 1976. These original at-risk rules were limited in their application to four specific activities. A separate at-risk rule was enacted for partnerships, but real estate was not covered. Later, the rules were expanded to cover most activities, and the special partnership rule was dropped from the tax code; but again, real estate was exempted. In the Tax Reform Act of 1986, Congress finally extended the at-risk rules to real estate investments beginning in 1987, but limited the impact of the change by allowing nonrecourse financing from certain sources ("qualified nonrecourse financing") to be counted as amounts at risk.

Under the at-risk rules,<sup>22</sup> deductions from covered activities or investments are limited to the sum of the following amounts:

1. Money actually invested;
2. The adjusted basis of other property contributed to the activity;
3. Amounts borrowed for the activity for which the taxpayer is personally liable for repayment;
4. Amounts borrowed for the activity for which the taxpayer has pledged security property, other than property used in the activity, to the extent of the fair market value of the taxpayer's interest in the pledged property (but not if the pledged property has been financed with nonrecourse debt); and
5. Qualified nonrecourse financing for real estate.

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<sup>22</sup> Code Sec. 465.

Note that tax basis generally is not affected by the at-risk rules other than for the purpose of determining any available investment credit. Tax basis is still determined under the rules discussed in Chapter 1, but losses (deductions) from an activity cannot exceed the amount considered at risk in the activity. For instance, depreciation (see Chapter 9) is still calculated on tax basis, which may include nonrecourse debt, but the owner of the property cannot deduct losses generated by the depreciation deductions in excess of the amount at risk.

### ¶ 313 Taxpayers and Activities Subject to the Rules

Taxpayers subject to the at-risk rules are:

1. Individuals;
2. Shareholders in S corporations; and
3. Corporations in which one-half of the stock (measured by value) is owned by five or fewer persons.<sup>23</sup>

There is a special exception for regular C corporations (but not S corporations) that are actively engaged in a trade or business other than a business involving master sound recordings, motion pictures, video tapes, or assets associated with literary, artistic, musical, or similar properties. This exception to the at-risk rules for regular corporations actively engaged in a trade or business, however, does not apply to personal holding companies and certain personal service corporations.<sup>24</sup> Also, regular corporations involved in equipment leasing are subject to the at-risk rules unless 50 percent or more of the corporation's gross receipts are from leasing or selling equipment.<sup>25</sup>

The at-risk rules generally apply to all activities including, since 1987, real estate. Each activity is treated separately under the rules, and a taxpayer cannot combine income from one activity and losses from another activity. There are, however, exceptions that permit the aggregation of income and losses from otherwise separate activities. Activities in connection with a trade or business are combined and treated together for purposes of applying the at-risk rules in the following situations:

1. If the person claiming the loss actively participates in the management of the business.<sup>26</sup>

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<sup>23</sup> Code Sec. 465(a)(1).

<sup>25</sup> Code Sec. 465(c)(4).

<sup>24</sup> Code Sec. 465(c)(7).

<sup>26</sup> Code Sec. 465(c)(3)(B)(i).

2. If in a partnership or S corporation 65 percent or more of any losses go to partners or shareholders who actively participate in management.<sup>27</sup>
3. If a partnership or S corporation is engaged in equipment leasing, all leasing activities are treated together as a single activity.<sup>28</sup>

Generally, the aggregation rules in 1 and 3, above, apply to the activity of holding real property. Under these rules, if a taxpayer actively participates in the management of several partnerships, each engaged in a real estate business, the real estate activities of the various partnerships may be aggregated and treated as one activity as to that partner for purposes of the at-risk rules. Also, in the case of an affiliated group of corporations which is engaged principally in the real estate business, aggregation of the real estate activities is allowed if the component members of the group are actively engaged in the management of the real estate business (not including real estate financing other than between members of the affiliated group).<sup>29</sup>

### ¶ 315 Deduction Under the At-Risk Rules

In any tax year, there are two ways in which deductions generated by an activity subject to the at-risk rules may be allowed.<sup>30</sup> First, deductions from an activity may be taken to the extent of income received or accrued from the activity in that taxable year. Income, in this case, includes gain on a sale of assets whether that gain is long- or short-term. Simply put, there are no at-risk limitations on deductions from an activity to the extent that activity is also producing income. In other words, deductions generated by an activity may always be used to offset income generated by that activity.

In addition to deductions equal to income, deductions may be taken in excess of income from the activity to the extent the taxpayer is at risk.

**Example:** In 2002, the Taxpayer, who is on the calendar year, invested \$50,000 in an activity subject to the at-risk rules by putting up \$10,000 cash and obtaining nonrecourse financing for the balance. The Taxpayer's cost basis is \$50,000, but the Taxpayer is at risk for only \$10,000. At the end of 2002, the Taxpayer has a loss of \$15,000 from the activity as a result of deductions generated by the activity.

<sup>27</sup> Code Sec. 465(c)(3)(B)(ii).

<sup>30</sup> Prop. Reg. § 1.465-2(a).

<sup>28</sup> Code Sec. 465(c)(2)(B)(i).

<sup>29</sup> See the Senate Finance Committee Report on the Tax Reform Act of 1986, P.L. 99-514.

The \$15,000 loss reduces the Taxpayer's basis so that at the end of 2002 the Taxpayer's adjusted basis is \$35,000. Of the \$15,000 loss, however, the Taxpayer may deduct only \$10,000 for 2002, the amount at risk. This deduction reduces the Taxpayer's amount at risk in the activity to zero. The balance of the loss, \$5,000, is disallowed, but it may be carried over to be used against future income or if the Taxpayer otherwise increases the amount at risk in the activity.<sup>31</sup>

Assume that at the beginning of 2003, the Taxpayer sells the activity for the amount of the nonrecourse debt, or \$40,000. Since the Taxpayer's adjusted basis is \$35,000, the sale produces a \$5,000 gain. Since this gain is income from the activity, the disallowed loss from 2002 that is carried over to 2003 may be taken as a deduction for 2003 to the extent of this income. Accordingly, the Taxpayer reports the \$5,000 as income for 2003, but the Taxpayer also can deduct the \$5,000 loss that was previously disallowed.

For additional examples of permitted deductions under the at-risk rules, see Prop. Reg. § 1.465-11.

### ¶ 315.1 *Order of Deductions*

When deductions from an activity exceed the amount at risk, the deductions are applied to the at-risk amounts and taken in the following order:<sup>32</sup>

1. Capital losses
2. All deductions that enter into the computation of Code Sec. 1231 gains and losses
3. Deductions that are not tax preferences under Code Sec. 57, to the extent not deducted under 1 or 2
4. All items of tax preference to the extent not deducted under 1 or 2

Deductions that are disallowed under the at-risk rules retain their identity according to this classification in succeeding years.

**Example:** The Taxpayer, who is on the calendar year, is engaged in an activity subject to the at-risk rules. At the end of 2002, the Taxpayer has \$1,000 at risk in the activity. During 2003, the activity generates \$3,000 of income and \$7,500 in deductions. None of the deductions are capital losses or items subject to Code Sec. 1231, but \$5,000 of the deductions are tax preferences. Assuming nothing else occurred in 2003 to affect the Taxpayer's amount

<sup>31</sup> Prop. Reg. § 1.465-2(b).

<sup>32</sup> Prop. Reg. § 1.465-38.

at risk, the Taxpayer will be allowed \$4,000 of deductions, and \$3,500 will be disallowed by the at-risk rules. The \$4,000 of allowed deductions will consist of the entire \$2,500 of deductions that are not tax preferences and \$1,500 of the \$5,000 of tax preferences. The disallowed deductions in the amount of \$3,500 will be carried over and will retain their classification as tax preferences for purposes of applying them against future income from the activity or increases in the Taxpayer's amount at risk in the activity.

### ¶ 315.2 *Recapture of Prior Deductions*

Prior loss deductions that were allowed against amounts at risk in an activity must be recaptured and reported as income if an amount formerly at risk in the activity is converted to a nonrecourse liability or otherwise is no longer at risk.<sup>33</sup>

**Example:** The Taxpayer invested \$100,000 in an activity in the form of \$10,000 cash and \$90,000 obtained through a recourse loan. The Taxpayer's original amount at risk in this activity, therefore, was \$100,000. After taking \$50,000 in loss deductions generated by this activity, the \$90,000 recourse loan is converted to a nonrecourse loan. The Taxpayer now must report \$40,000 of income, which represents a recapture of prior loss deductions to the extent the Taxpayer is no longer at risk.

### ¶ 317 *Determining Amount at Risk*

Amounts at risk in an activity include the amount of money invested, the adjusted basis of any property contributed to the activity, and borrowed amounts for which the borrower is personally liable for repayment or has pledged property, other than property in the activity, to secure payment. Amounts at risk in the case of a real estate activity also include qualified nonrecourse financing, which is separately discussed below. Amounts at risk do not include any amount protected against loss by nonrecourse financing (other than qualified nonrecourse financing for real estate), guarantees, stop-loss arrangements, or any other similar arrangement.<sup>34</sup>

The amount at risk in an activity for subsequent years is reduced by any allowable loss for the current year.<sup>35</sup>

<sup>33</sup> Code Sec. 465(e).

<sup>34</sup> Code Sec. 465(b)(4). See also Rev. Rul. 85-113, 1985-1 CB 184 (purported recourse note ruled nonrecourse because borrower could assign percentage of mine production in satisfaction of debt), and Rev.

Rul. 80-72, 1980-1 CB 109 (option amounted to "other similar arrangement" to nonrecourse financing).

<sup>35</sup> Code Sec. 465(b)(5).

### ¶ 317.1 *Borrowed Amounts*

Borrowed money is not included in the amount at risk if the money is borrowed from a person who has an interest in the activity other than as a creditor or who is related to a person who has an interest in the activity other than as a creditor.<sup>36</sup> Related persons include brothers and sisters, spouses, ancestors, and lineal descendants; shareholders and 10 percent-owned corporations; partners and 10 percent-owned partnerships; beneficiaries and fiduciaries of a trust; and fiduciaries and grantors of a trust.

A special provision in Code Sec. 465(b)(2) prevents the use of circular arrangements to avoid the at-risk rules. For instance, if a taxpayer borrows money secured by livestock to buy real estate and borrows money secured by the real estate to pay for the livestock, none of the borrowed amounts would be considered at risk in either the livestock activity or the real estate activity.

#### *Discounted Loans*

In a case involving a recourse note that was not due for 10 years and for which the taxpayers were not liable for the stated interest on the note, the IRS asserted that the amount at risk should be discounted to reflect the time-value of money and that there was no personal liability for the interest. The Tax Court, however, ruled that the note did not have to be discounted to its value at the time of execution for purposes of determining the borrowed amount under the at-risk rules. The Court held that the tax code does not expressly or implicitly authorize a present value calculation in determining the borrowed amount.<sup>37</sup>

#### *Guaranteed Loans*

If a taxpayer guarantees repayment of an amount borrowed by another person (the primary obligor) for use in an activity, the guarantee does not increase the taxpayer's amount at risk.<sup>38</sup> If the taxpayer repays to the creditor the amount borrowed by the primary obligor, the taxpayer's amount at risk is increased when the taxpayer has no remaining legal rights against the primary obligor.

In *L.A. Bjerke*,<sup>39</sup> a limited partner was not entitled to deduct partnership losses based on debts that the partner guaranteed. The partnership debts that the partner guaranteed were not at risk because the partner could recover from the partnership as the primary obligor on the debt any guaranteed amounts that the partner might be compelled to pay.<sup>40</sup>

<sup>36</sup> Code Sec. 465(b)(3).

<sup>37</sup> *D.B. Follender*, 89 TC 943, CCH Dec. 44,305, Acq. 1989-1 CB 1.

<sup>38</sup> Prop. Reg. § 1.465-6(d).

<sup>39</sup> DC N.D., 87-2 USTC ¶ 9576, 677 F.Supp. 633.

<sup>40</sup> See also *E.H. Allen*, 55 TCM 641, CCH Dec. 44,718(M), T.C. Memo. 1988-166.

A limited partner was held to be at risk for the allocable share of the partnership's recourse indebtedness when the limited partner entered into legally enforceable contracts making the partner personally and ultimately liable for the share of the partnership's debt.<sup>41</sup> Since there was no primary obligor against whom the limited partner could recover amounts paid, the court concluded that the partner was not a mere guarantor of the share of the partnership's recourse debt but was ultimately liable for it.<sup>42</sup>

### ¶ 317.2 *Avoidance of At-Risk Rules*

Knowing that taxpayers would attempt to get around the at-risk rules whenever possible, the IRS has put forth some proposed regulations that are designed to block such attempts. These regulations are directed against arrangements that are outside of normal commercial practices or that are designed to convert recourse debt to nonrecourse debt.

#### *Beyond Normal Commercial Practice*

The proposed at-risk regulations state that if a taxpayer engages in conduct that is not within "normal commercial practice" or has the effect of avoiding the at-risk rules, the amount at risk may be adjusted to reflect more accurately the amount that is actually at risk.<sup>43</sup> For instance, if an event increases the amount at risk near the close of the taxable year and has the effect of increasing the amount of losses that can be deducted, and a corresponding event decreases the amount at risk after year-end, these amounts will be disregarded unless there is a valid business reason for the arrangement and the arrangement is not a device to avoid the at-risk rules.

The circumstances the IRS considers in deciding whether to adjust the amount at risk include:

1. The length of time between an increase and decrease in the amount at risk;
2. The nature of the activity and deviations from normal business practice in the conduct of the activity;
3. The use of those amounts that increased the amount at risk toward the close of the tax year;
4. Contractual arrangements between parties to the activity; and
5. The occurrence of unanticipated events which make a decrease in the amount at risk necessary.

<sup>41</sup> T.S. Ockles, 54 TCM 785, CCH Dec. 44,245(M), T.C. Memo. 1987-507.

<sup>42</sup> IRS Letter Ruling 8749009, August 21, 1987.

<sup>43</sup> Prop. Reg. § 1.465-4(a).

### *Recourse Liabilities Becoming Nonrecourse*

If liabilities are recourse for a period of time and then later become nonrecourse, the amount of liabilities during the period they are recourse will be considered at risk only if the arrangement is primarily business motivated and consistent with the normal commercial practice of financing the activity for which the money is borrowed.<sup>44</sup>

In Rev. Rul. 82-225,<sup>45</sup> the IRS ruled that an investor was not at risk for a recourse note that could be converted into a nonrecourse note because the criteria for conversion did not require that the underlying property be of sufficient value to cover the amount of the note. Similarly, in *J. Porreca*,<sup>46</sup> a taxpayer that had a unilateral right to convert recourse notes to nonrecourse notes was not at risk because the right to convert was not tied to any substantial economic event.

A taxpayer was considered at risk, however, for a recourse note that was convertible to a nonrecourse note because substantial amounts were due and paid prior to the conversion of the note. The note could only be converted if payments were not in arrears. Also, the note provided no right to make up delinquencies, and payment was not contingent on the proceeds from the underlying activity. The at-risk amount, however, was limited to the extent of the payments made prior to conversion.<sup>47</sup>

### ¶ 317.3 *Computation of At-Risk Amount*

To determine the amount at risk in an activity for a particular tax year, one begins with the at-risk amount at the end of the previous year and adjusts that amount for events occurring during the current year. The following summarizes the events that increase or decrease the amount at risk in an activity.

#### *Increase Amount At Risk for:*

- Money contributed
- Income from activity in excess of deductions
- Property contributed, measured by its adjusted basis (even if property is encumbered, but only to the extent that the taxpayer is personally liable)
- Loans for which the taxpayer is personally liable
- Loans secured by property not in the activity, limited to the fair market value of the property (but a later contribution of the property to the activity will reduce at-risk amount)
- Loans that are qualified nonrecourse financing for real estate

<sup>44</sup> Prop. Reg. § 1.465-5.

<sup>45</sup> 1982-2 CB 100.

<sup>46</sup> 86 TC 821, CCH Dec. 43,022.

<sup>47</sup> *L. Lansburgh*, 53 TCM 454, CCH Dec. 43,803(M), T.C. Memo. 1987-164; 54 TCM 691, CCH Dec. 44,227(M), T.C. Memo. 1987-491.

*Decrease Amount At Risk for:*

- Money withdrawn
- Loss allowed
- Property withdrawn or distributed from the activity, measured by adjusted basis of the property in the taxpayer's hands less liabilities to which the property is subject and for which the taxpayer is not personally liable

The following example illustrating the application of the at-risk rules and the provisions of the proposed at-risk regulations is drawn from Prop. Reg. § 1.465-41.

**Example:** On January 1, 1990, A and B form an equal partnership called the AB partnership. A and B each contribute \$5,000 to the partnership on January 1. On August 1, 1990, AB borrows \$6,000 from a bank and A and B assume personal liability. On December 31, 1990, the bank loan is reduced to \$4,500. There is no income or loss for 1990. A's at-risk amount is calculated as follows:

At risk January 1, 1990 .....	\$ 0
Plus: Contributions .....	5,000
Share of loan for which A has personal liability .....	3,000
	\$8,000
Less: Share of loan reduction .....	750
At risk December 31, 1990 .....	\$7,250

On February 1, 1991, AB borrows \$20,000 on a nonrecourse basis with the loan secured by equipment. On May 1, 1991, the bank loan is reduced to \$4,000. On August 1, 1991, the nonrecourse loan is reduced to \$19,000. On October 1, 1991, AB distributes \$2,000 to each of its partners. On December 1, 1991, the bank loan is reduced to \$2,500. On December 31, 1991, A and B are each allocated their \$3,000 share of AB income for 1991. A's at-risk amount for 1991 is calculated as follows:

At risk January 1, 1991 .....	\$ 7,250
Plus: Income from activity .....	3,000
	\$10,250
Less: Share in bank loan reductions .....	1,000
	\$ 9,250
Less: Distribution .....	2,000
At risk December 31, 1991 .....	\$ 7,250

Note that since the loans were repaid with money in the activity, the repayment to the bank reduced the amount at risk, and the repayment on the nonrecourse debt did not increase the amount at risk.

On March 1, 1992, A and B each contribute \$1,000 to the partnership. On September 1, 1992, A and B each contribute \$1,500. AB reduces the bank loan to zero by paying \$2,500. AB pays \$500 on the nonrecourse loan. On December 31, 1992, A and B have \$10,500 allocated to each of them as their shares of AB losses. A's at-risk amount for 1992 is calculated as follows:

At risk January 1, 1992 .....	\$7,250
Plus: Contributions .....	2,500
	\$9,750
Less: Share of bank loan reduction .....	1,250
At risk December 31, 1992 .....	\$8,500

Since A's loss allocation for 1992 is \$10,500, but the at-risk amount is \$8,500, A's loss deduction is limited. A deducts \$8,500 of the loss for 1992, and this reduces the at-risk amount as of December 31, 1992 to zero. The \$2,000 loss that is not allowed is treated as a loss in 1993.

During 1993, A and B each contribute \$1,000 to the AB partnership. On December 31, 1993, A and B are each allocated \$500 of income. A's at-risk amount for 1993 is calculated as follows:

At risk January 1, 1993 .....	\$8,500
Less: Loss allowed for 1992 .....	8,500
	\$ 0
Plus: Contribution .....	1,000
At risk December 31, 1993 .....	\$1,000

Of the \$2,000 loss not allowed in 1992, \$500 is deductible due to 1993 income and \$1,000 is deductible because A is at risk for 1993 to this extent. The remaining \$500 of the loss is not deductible in 1993 but it is carried over and treated as a loss for the following year. A begins 1994 with an at-risk amount of zero.

### ¶ 319 Qualified Nonrecourse Financing

One reason real estate was exempted from the at-risk rules until 1987 was that it was generally thought that real estate investments were not subject to the abusive uses of nonrecourse financing to the same extent as other investments. Real estate has value that generally

does not depreciate rapidly (in fact, it usually appreciates) and, therefore, investors have an incentive to protect their ownership of real estate even when financed on a nonrecourse basis. Abuse in real estate investments generally occurred when the nonrecourse financing was provided by the seller or promoter of the investment and the purchase price was set far above the actual fair market value of the property. With this in mind, when Congress extended the at-risk rules to real estate, it limited their application to truly abusive situations. Accordingly, qualified nonrecourse financing is treated as at risk under the rules.<sup>48</sup>

Qualified nonrecourse financing that is considered at risk must meet four requirements:

1. The borrowing must be for the activity of holding real property. Holding real property includes the holding of personal property and the provision of services that are incidental to the use of real property.
2. The borrowing must be from a qualified person or from any federal, state or local government or government instrumentality, or the loan must be guaranteed by federal, state or local government. Qualified persons include any person actively and regularly engaged in the business of lending money such as a bank, savings and loan, credit union, insurance company, or pension trust. Qualified persons do not include any person from which the taxpayer acquires the property or any person who receives a fee from the taxpayer's investment in the property or persons related to such persons. (Seller financing or promoter financing can never be qualified nonrecourse financing.)
3. No person may be personally liable for the financing, except as provided in regulations.
4. The borrowing may not be convertible debt.<sup>49</sup>

### ¶ 319.1 **Financing from Related Person**

Qualified nonrecourse financing may be obtained from a related person, but, if it is, the terms of the borrowing must be commercially reasonable and on substantially the same terms as loans involving unrelated persons.

According to the Conference Committee Report on the Tax Reform Act of 1986, the terms of nonrecourse financing are commercially reasonable if the financing is a written unconditional promise to pay on demand or on a specified date or dates a sum or sums certain in money,

<sup>48</sup> Code Sec. 465(b)(6).

<sup>49</sup> Prop. Reg. § 1.465-27.

and the interest rate is a reasonable market rate of interest, taking into account the maturity of the obligation.

Generally, an interest rate is not considered commercially reasonable if it is significantly below the market rate on comparable loans by qualified persons who are not related to the borrowers. Similarly, an interest rate that significantly exceeds the market rate on comparable loans by unrelated qualified persons is not considered commercially reasonable. Also, an interest rate that is contingent is not commercially reasonable, but floating rates keyed to a market index are permitted.

The terms of financing are not considered commercially reasonable if the term of the loan exceeds the useful life of the property. Also, if the right to foreclose or collect is limited, except to the extent provided under state law, the terms of the loan are not commercially reasonable. The intent of Congress, generally, is to limit qualified nonrecourse financing to financing that carries arm's-length terms.

### **¶ 319.2 *Transfer of Property***

A taxpayer who acquires property subject to a nonrecourse debt that constituted qualified nonrecourse financing in the hands of the original borrower also may treat the debt as qualified nonrecourse financing, provided all the requirements are met. The same rule applies to subsequent transfers of the property taken subject to the debt, and to the admission of new partners to a partnership and the sale or exchange of a partnership interest, so long as the debt constitutes qualified nonrecourse financing as to each transferee or new partner.

### **¶ 321 INTEREST**

Interest is compensation for the use or forbearance of money. It is the cost paid by the owner of real estate for the use of another's money to finance the acquisition. In the case of the supplier of the money, it is the "rent" received while another makes use of the money.

At one time, it may have been possible to say simply that interest paid is deductible and interest received is income when the acquisition of real estate is financed through a mortgage or other lending arrangement. Such is not the case today. Massive changes in the tax code in recent years have created traps and pitfalls that must be carefully negotiated when structuring a loan transaction. While most of the complications focus on interest as a deductible expense, certain provisions affect both the borrower and the lender, either as to the amount or timing of interest income and expense, or both. These provisions include the rules on interest-free and below-market rate loans and the original issue discount and imputed interest rules for deferred payment sales.

### ¶ 323 Interest Income

Interest received by a mortgage lender is taxable income.<sup>50</sup> Interest income includes interest on a promissory note, a mortgage, and the interest portion of a condemnation award. Interest income also includes usurious interest, unless the usurious interest is automatically converted to principal payments under state law.<sup>51</sup> Prepayment penalties or premiums charged for the prepayment of a mortgage also are taxable as interest income to the recipient.<sup>52</sup>

Interest income, generally, is reported in the year it is received by a cash basis taxpayer and in the year it is earned by an accrual basis taxpayer.<sup>53</sup> An accrual basis taxpayer who receives an actual prepayment of interest, however, generally must report the interest income when received.<sup>54</sup> See, for example, *J.A. Mele*,<sup>55</sup> in which interest prepaid for five years on a promissory note was held accruable when received and could not be prorated over the five-year period; and *Bjornsen Investment Corp.*,<sup>56</sup> in which prepaid interest received by an accrual basis taxpayer in connection with a 20-year real estate contract was held taxable in full at time of receipt.

Mortgage discount points charged to the seller by a mortgagee and deducted from the proceeds of the mortgage loan before they are paid to the seller, however, are not included in the mortgagee's income for the year the mortgage is originated.<sup>57</sup> The discount is included in income ratably as payments are received from the buyer.<sup>58</sup>

Keep in mind that the general rule regarding the amount and timing of interest income may be affected by the original issue discount and imputed interest rules for deferred payment sales which are discussed below.

### ¶ 325 Interest Deduction

Code Sec. 163(a) states the general rule that a deduction is allowed for "all interest paid or accrued within the taxable year on indebtedness." Unfortunately, a plethora of other code provisions makes this general rule almost meaningless by limiting or denying completely deductions for interest relating to certain types of indebtedness. The provisions likely to apply to real estate financing include:

1. The deduction for interest on investment indebtedness is limited by Code Sec. 163(d) (see ¶ 325.2).

<sup>50</sup> Code Sec. 61.

<sup>51</sup> Reg. § 1.61-7.

<sup>52</sup> *General American Life Insurance Co.*, 25 TC 1265, CCH Dec. 21,631, Acq. 1956-2 CB 5.

<sup>53</sup> Code Sec. 451.

<sup>54</sup> Rev. Rul. 70-540, 1970-2 CB 101.

<sup>55</sup> 61 TC 358, CCH Dec. 32,260, Acq. 1975-1 CB 2.

<sup>56</sup> DC Iowa, 81-1 USTC ¶ 9258.

<sup>57</sup> Rev. Rul. 65-95, 1965-1 CB 208.

<sup>58</sup> IRS Letter Ruling 7820003, January 20, 1978.

2. Interest on personal debts is disallowed by Code Sec. 163(h), other than certain home mortgage debt (see ¶ 1703.3).
3. Interest incurred during the construction of real estate generally must be capitalized under Code Sec. 263A (see ¶ 127).
4. Interest that qualifies as carrying charges on certain real estate may be capitalized under Code Sec. 266 (see ¶ 135).
5. An accrual basis taxpayer may deduct interest paid to a related cash basis taxpayer only when actually paid.<sup>59</sup>
6. Prepaid interest generally must be capitalized and deducted ratably over the term of the loan under Code Sec. 461(g) (see ¶ 325.1).
7. Deductible interest may be limited under the at-risk rules of Code Sec. 465 (see ¶ 311).
8. Deductible interest may be limited under the passive loss limitations of Code Sec. 469 (see ¶ 1143.2).

To be deductible, generally, interest must be paid on the indebtedness of the taxpayer. In the case of interest paid by the legal or equitable owner on a mortgage on real property, the interest is deductible even if the owner is not directly liable on the bond or note secured by the mortgage.<sup>60</sup> Also, annual or periodic payments made under a redeemable ground rent are treated as interest payments under the tax code.<sup>61</sup> For instance, payments made under an agreement subject to the residential ground rent laws of Virginia are treated as interest.<sup>62</sup> Payments on nonredeemable ground rents, however, are not treated as interest, although the payments may be deductible if they qualify as a business or investment expense.

Subject to the special rules listed above, the general rule is that a cash basis taxpayer deducts interest when actually paid, and an accrual basis taxpayer deducts interest as it accrues ratably over the term or period of the debt.<sup>63</sup> For an accrual basis taxpayer, it is not material when actual payment occurs.<sup>64</sup> An accrual basis taxpayer, however, is placed on the cash method of accounting as to interest paid to a related cash basis person.<sup>65</sup> This rule prevents a related payor from taking advantage of an interest deduction before the interest is includible in the income of the recipient. The relationships covered by this rule are listed in Code Sec. 267(b) and include family members, controlled corporations, and various fiduciary relationships.

<sup>59</sup> Code Sec. 267.

<sup>60</sup> Reg. § 1.163-1(b).

<sup>61</sup> Code Sec. 163(c).

<sup>62</sup> Rev. Rul. 75-281, 1975-2 CB 65.

<sup>63</sup> Code Sec. 446; Reg. § 1.446-1(c).

<sup>64</sup> Rev. Rul. 68-643, 1968-2 CB 76.

<sup>65</sup> Code Sec. 267.

Cash basis taxpayers generally are allowed interest deductions only for interest actually paid in cash or its equivalent. Personal notes given to a creditor for interest due are not considered cash or its equivalent.<sup>66</sup> The IRS has announced that it will disallow any deduction claimed for interest paid on a loan if the payment is made with money obtained from the original creditor through a second loan, an advance, or any other arrangement that is similar to a loan.<sup>67</sup> A deduction is allowed, however, if the taxpayer borrows money from a third party and uses that money to pay interest which is owed to the original lender.

### ¶ 325.1 *Prepaid Interest*

An accrual basis taxpayer can deduct prepaid interest only in the period in which the use of money occurs and only to the extent of the interest cost of using the borrowed funds during that period. It is not material when actual payment occurs, and the existence of a fixed liability to make a prepayment of interest is not sufficient to justify a deduction.<sup>68</sup> Code Sec. 461(g) makes cash basis taxpayers subject to essentially the same rule.

Under Code Sec. 461(g), a cash basis taxpayer who pays interest that is properly allocable to a later tax year must charge that interest to a capital account and treat it as paid in the periods in which the interest represents a charge for the use or forbearance of borrowed money during each year. Interest on a “wraparound mortgage” is subject to this prepaid interest rule, although the IRS may recharacterize part or all of a borrower’s “interest” payment on a wraparound mortgage as, in substance, an additional down payment of principal or as a nondeductible deposit of interest with a third party.<sup>69</sup>

Once prepaid interest is allocated over the term of the loan, then it becomes subject to the various other provisions that restrict or limit the deduction for interest.

Points are additional interest charges that are usually paid when a loan is closed and that generally are imposed by the lender in lieu of a higher interest rate. If points are paid as compensation for the use of borrowed money, and are therefore considered interest, rather than as payment for the lender’s services, the points are prepaid interest and must be treated as paid over the term of the loan. Points paid in refinancing a mortgage are subject to this rule,<sup>70</sup> but an exception applies to points or prepaid interest to the extent the underlying debt is

<sup>66</sup> Rev. Rul. 70-647, 1970-2 CB 38.

<sup>67</sup> IRS News Release 83-93, July 6, 1983; see also *W.M. Roberts*, 53 TCM 787, CCH Dec. 43,900(M), T.C. Memo. 1987-235.

<sup>68</sup> Rev. Rul. 68-643, 1968-2 CB 76.

<sup>69</sup> Rev. Rul. 75-99, 1975-1 CB 197.

<sup>70</sup> Rev. Rul. 87-22, 1987-1 CB 146.

incurred for the purchase or improvement of the taxpayer's principal residence (see ¶ 1705).<sup>71</sup>

### **¶ 325.2 *Investment Interest***

For noncorporate taxpayers, the deduction of "investment interest" is limited by Code Sec. 163(d). Generally, a noncorporate taxpayer may deduct investment interest only to the extent of net investment income. Any investment interest disallowed as a deduction under this provision may be carried over and deducted against investment income realized in future years.

Investment interest includes interest on debt attributable to property that produces interest income, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. Investment interest also includes interest on debt allocable to oil and gas activities that are not passive activities and that constitute a trade or business. Also, interest expense allocable to portfolio income under the passive loss rules (see ¶ 1143.1) and interest allocable to personal property used in a short sale is investment interest.

Investment interest does not include qualified residence interest (see ¶ 1703) or interest that is taken into account under the passive loss rules explained at ¶ 1103. Also, interest on debt allocable to rental real estate in which the taxpayer actively participates within the meaning of the passive loss rules is not considered investment interest.

Investment income is the income from property held for investment and includes capital gain derived from the sale of investment property. It includes interest income, dividends, annuities, and royalties not derived in the ordinary course of business, and income from activities that are trades or businesses in which the taxpayer does not materially participate but that are not passive activities under the passive loss rules.

Investment income must be reduced by investment expenses to determine the ceiling amount for the deduction of investment interest. Investment expenses are any expenses other than interest that are deductible in connection with the production of investment income. Deductible expenses are those allowed after the application of the two percent of adjusted gross income floor for the deduction of miscellaneous expenses by individual taxpayers. In computing the amount of investment expenses that exceed the two percent floor, non-investment expenses are disallowed before the disallowance of any investment expenses.

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<sup>71</sup> Code Sec. 461(g)(2).

Investment income and expenses do not include any items taken into account under the passive loss rules.<sup>72</sup> (See Chapter 11 for a detailed discussion of the passive loss rules.)

### ***Rental Real Estate***

As noted above, interest on debt allocable to rental real estate in which the taxpayer actively participates within the meaning of the passive loss rules is not considered investment interest. Rental activities in which the taxpayer does not actively participate generally are considered passive activities under the passive loss rules. Therefore, income from such rental activities and interest on debt attributable to such activities would be covered by the passive loss rules and would not enter into the computation of the investment interest limitation.

Prior to 1987, interest on debt attributable to real property subject to a net lease was investment interest and income produced by net lease property was investment income. Now, of course, real property subject to a net lease produces income and loss subject to the passive loss rules, and not the investment interest limitation.

### ***Vacant Land***

Vacant land presents special problems in connection with the investment interest limitation. If land is acquired for investment, then interest on mortgages on that land would be investment interest deductible only to the extent of investment income.

Land, however, may be acquired for a number of reasons. A taxpayer may take the position that vacant land is acquired and held as part of a trade or business, that is, that the taxpayer is a dealer in property. In this case, interest attributable to debt on the land would not be subject to the investment interest limitation, but the sale of land would produce ordinary income, not capital gain.

Vacant land also may be acquired in order to construct rental real estate. If the rental real estate is a passive activity, then the interest on the land presumably would be governed by the passive loss rules rather than the investment interest limitation.

### **¶ 325.3 *Tracing Debt Proceeds***

The number of limitations and restrictions on the deduction of interest requires that some way be found to classify interest under the various categories—fully deductible interest relating to a trade or business, investment interest subject to the Code Sec. 163(d) limitation, passive activity interest subject to the Code Sec. 469 passive loss rules,

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<sup>72</sup> Code Sec. 163(d)(4)(D).

and personal interest (other than qualified personal residence interest) disallowed under Code Sec. 163(h).

In general, the IRS has prescribed regulations<sup>73</sup> that call for interest expense on a debt to be allocated in the same manner as the debt to which the interest relates is allocated. Debt is allocated by tracing disbursements of debt proceeds to specific expenditures.<sup>74</sup> In other words, debt proceeds and related interest expense are allocated based entirely on the use of the proceeds. The allocation is not affected by the type of property (other than in the case of qualified residence interest) that is used to secure the debt.<sup>75</sup>

**Example:** The Taxpayer pledges corporate stock held for investment to secure a loan and uses the proceeds to purchase an automobile for personal use. Interest expense accruing on the debt is personal interest even though the debt is secured by investment property. If the automobile were used in the Taxpayer's trade or business, the interest would be business interest.

The amount of interest expense that accrues during any period is determined by taking into account relevant loan provisions and any applicable Internal Revenue Code provision that affects the accrual of interest expense, such as the original issue discount and imputed interest rules.<sup>76</sup>

### *Loan Proceeds Not Paid to Borrower*

If a lender disburses debt proceeds to a person other than the borrower for the sale or use of property, for services, or for any other purposes, the debt is treated as if the borrower used the debt proceeds for the property, services, or other purpose.<sup>77</sup> The same tracing rule applies if a taxpayer incurs or assumes a debt for the sale or use of property, for services, or for any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer.

### *Loan Proceeds Received in Cash*

Generally, any debt proceeds a taxpayer (other than a corporation) receives in cash (including withdrawal of cash from an account) are treated as used to make personal expenditures.<sup>78</sup> The taxpayer, however, may treat any cash expenditure made within 15 days after receiving the cash as made from the debt proceeds and may treat the expenditure as made on the date the cash was received.<sup>79</sup>

<sup>73</sup> Temp. Reg. § 1.163-8T.

<sup>74</sup> Temp. Reg. § 1.163-8T(a)(3).

<sup>75</sup> Temp. Reg. § 1.163-8T(c)(1).

<sup>76</sup> Temp. Reg. § 1.163-8T(c)(2)(C).

<sup>77</sup> Temp. Reg. § 1.163-8T(c)(3).

<sup>78</sup> Temp. Reg. § 1.163-8T(c)(5)(ii).

<sup>79</sup> Temp. Reg. § 1.163-8T(c)(5)(i).

**Example:** The Taxpayer incurs a \$1,000 debt on August 4 and receives the proceeds in cash. The Taxpayer deposits \$1,500 cash in an account on August 15 and on August 27 writes a check on the account for an investment expenditure. The Taxpayer also engages in many other cash transactions throughout the month of August, and numerous deposits of borrowed and unborrowed amounts and expenditures occur through the account. Despite these other transactions, the Taxpayer may treat \$1,000 of the deposit on August 15 as an expenditure made from the debt proceeds received on August 4. Also, the Taxpayer may treat the investment expenditure on August 27 as made from the \$1,000 debt proceeds treated as deposited in the account.

#### *Loan Proceeds Deposited in an Account*

The deposit of debt proceeds in an account is an investment expenditure, and an amount held in an account (whether or not interest bearing) is considered property held for investment. The debt must be reallocated when the proceeds are withdrawn and used to make another expenditure.<sup>80</sup>

**Example:** The Taxpayer borrows \$100,000 on January 1 and immediately uses the proceeds to open a noninterest-bearing checking account. No other deposits are made to the account and none of the loan is repaid during the year. On April 1, the Taxpayer uses \$20,000 from the account to make a passive activity expenditure. On September 1, the Taxpayer uses an additional \$40,000 for personal expenditures.

From January 1 through March 31, the entire \$100,000 debt is allocated to an investment expenditure and the interest on the debt is investment interest. From April 1 through August 31, \$20,000 of the debt is allocated to the passive activity, and \$80,000 is allocated to the investment expenditure. Interest for this period is investment interest to the extent attributable to the \$80,000 portion of the debt and interest subject to the passive loss rules to the extent attributable to the \$20,000 portion of the debt. From September 1 through December 31, \$40,000 of the debt is allocated to personal expenditures, \$20,000 to the passive activity, and \$40,000 to the investment expenditure. Interest on the debt is allocated accordingly.

When an account contains more than the proceeds of one loan and various deposits are made to the same account, an ordering rule is provided by Temp. Reg. § 1.163-8T(c)(4)(ii). Generally, debt proceeds deposited in an account are treated as expended before (1) any unbor-

<sup>80</sup> Temp. Reg. § 1.163-8T(c)(4)(i).

rowed amounts held in the account at the time the debt proceeds are deposited, and (2) any amounts (borrowed or unborrowed) that are deposited in the account after the debt proceeds are deposited.

**Example:** The Taxpayer opens a checking account on January 10 and deposits \$500 of proceeds of debt A and \$1,000 of unborrowed funds. The following summarizes the transactions through the account during the year:

January 10—\$500 Debt A and \$1,000 unborrowed funds deposited

January 11—\$500 proceeds of Debt B deposited

February 17—\$800 personal expenditure

February 26—\$700 passive activity expenditure

June 21—\$1,000 proceeds of Debt C deposited

November 24—\$800 investment expenditure

December 20—\$600 personal expenditure

The \$800 personal expenditure is treated as made from the \$500 proceeds of Debt A and \$300 of the proceeds of Debt B. The \$700 passive activity expenditure is treated as made from the remaining \$200 proceeds of Debt B and \$500 of unborrowed funds. The \$800 investment expenditure is treated as made entirely from the proceeds of Debt C. The \$600 personal expenditure is treated as made from the remaining \$200 proceeds of Debt C and \$400 of unborrowed funds. Debt is allocated to an investment expenditure for periods during which debt proceeds are held in the account.

Despite the general ordering rules, a taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited as made from the debt proceeds.<sup>81</sup>

**Example:** The Taxpayer incurs a \$1,000 debt on June 5 and immediately deposits the proceeds in an account (Account A). On June 17, the Taxpayer transfers \$2,000 from Account A to another account (Account B). On June 30, the Taxpayer writes a \$1,500 check on Account B for an investment expenditure. In addition, numerous deposits of borrowed and unborrowed amounts and expenditures occur through both accounts throughout the month of June.

The Taxpayer may treat \$1,000 of the deposit to Account B on June 17 as an expenditure from the debt proceeds deposited in Account A on June 5. Also, the Taxpayer may treat \$1,000 of the investment expenditure on June 30 as made from the debt proceeds treated as deposited in Account B on June 17.

<sup>81</sup> Temp. Reg. § 1.163-8T(c)(4)(iii)(B).

If the proceeds of two or more debts are deposited in an account simultaneously, the proceeds are treated as deposited in the order in which the debts were incurred. If two or more debts are incurred simultaneously, the debts may be treated as incurred in any order the taxpayer selects.<sup>82</sup>

### *Debt Repayments*

If debt is allocated to more than one expenditure when a portion of the debt is repaid, the debt is treated as repaid in the following order:

1. Amounts allocated to personal expenditures;
2. Amounts allocated to investment expenditures and passive activity expenditures other than rental real estate in which the taxpayer actively participates;
3. Amounts allocated to passive activity expenditures for rental real estate in which the taxpayer actively participates;
4. Amounts allocated to former passive activity expenditures; and
5. Amounts allocated to trade or business expenditures and to certain low-income housing projects.<sup>83</sup>

In the case of lines of credit or similar arrangements that permit borrowing periodically under a single loan agreement, all borrowings on which interest accrues at the same fixed or variable rate are treated as a single debt. Also, borrowings or portions of borrowings on which interest accrues at different fixed or variable rates are treated as different debts, and the debts are treated as repaid in the order in which the borrowings are treated as repaid under the loan agreement.<sup>84</sup>

### *Debt Refinancing*

To the extent the proceeds of any debt (the replacement debt) are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated. The amount of the replacement debt allocated is equal to the amount of debt allocated to the expenditures which was repaid with the proceeds of the replacement debt. If the replacement debt exceeds the repaid debt, the balance of the replacement debt is allocated to expenditures under the other tracing rules.<sup>85</sup>

### *Reallocation of Debt*

Debt allocated to an expenditure relating to an asset is reallocated to another expenditure on the earlier of:

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<sup>82</sup> Temp. Reg. § 1.163-8T(c)(4)(v).

<sup>83</sup> Temp. Reg. § 1.163-8T(d)(1).

<sup>84</sup> Temp. Reg. § 1.163-8T(d)(3).

<sup>85</sup> Temp. Reg. § 1.163-8T(e)(1).

1. The date on which proceeds from a disposition of the asset are used for another expenditure, but not in excess of the proceeds from the disposition of the asset; or
2. The date on which the character of the first expenditure changes because of a change in the use of the asset, but not in excess of the fair market value of the asset on the date of change.<sup>86</sup>

If the proceeds from the disposition of an asset exceed the amount of debt reallocated because of the disposition, or two or more debts are reallocated because of the disposition of the asset, the proceeds of the disposition are treated as an account to which the rules discussed above for loan proceeds deposited to an account apply.<sup>87</sup>

**Example:** On January 1, the Taxpayer sells an asset for \$25,000. Just prior to the sale, the amount of debt allocated to the asset was \$15,000. The proceeds of the disposition are treated as an account consisting of \$15,000 of debt proceeds and \$10,000 of unborrowed funds. If the Taxpayer immediately makes a \$10,000 personal expenditure from the proceeds and within 15 days deposits the remaining proceeds in a bank account, the Taxpayer may treat the entire \$15,000 deposited in the bank account as proceeds of a debt.

### ¶ 327 Interest-Free and Below-Market Rate Loans

In most contexts, an interest-free or below-market interest rate loan is really more than a simple borrow and lend transaction. Generally speaking, these loans are made in settings that are removed from traditional commercial lending and involve borrowers and lenders that have some relationship beyond mere debtor and creditor. In an effort to recognize the true nature of these transactions, Code Sec. 7872 takes certain interest-free and below-market rate loans and recharacterizes them as arm's-length transactions.

In a loan transaction recharacterized under Code Sec. 7872, the lender is considered to have made a loan at a rate of interest fixed by statute and also made an additional payment to the borrower equal to the foregone interest. This additional payment may be considered a gift, dividend, contribution to capital, compensation, or some other payment, depending on the context of the loan. The borrower, in turn, is considered to have transferred back to the lender the amount of this foregone interest as an interest payment.

The amount of foregone interest is based on the "applicable federal rates" determined under the original issue discount rules.<sup>88</sup> These rates

<sup>86</sup> Temp. Reg. § 1.163-8T(j)(1).

<sup>87</sup> Temp. Reg. § 1.163-8T(j)(2).

<sup>88</sup> Code Sec. 1274(d).

are announced by the IRS each month. For term loans, the federal short-term rate is used for loans of three years or less, the federal mid-term rate for loans of more than three years but not more than nine years, and the federal long-term rate for loans with terms of more than nine years. For demand loans, the short-term rate is used. A special blended rate may be used when an interest-free or below-market rate loan remains outstanding for the entire calendar year.<sup>89</sup> Numerous examples illustrating the computation of foregone interest may be found in Prop. Reg. § 1.7872-13.

The rules of Code Sec. 7872 apply to interest-free and below-market loans made in the following contexts.<sup>90</sup>

1. **Gifts**—These are loans in which the foregone interest is in the nature of a gift and generally involve family members, although it is possible for there to be a gift loan between other than family members.
2. **Compensation**—These are loans made in connection with the performance of services between an employer and employee, an independent contractor and the person hiring the contractor, or a partner and partnership if the loan is for services by the partner other than in the capacity as a partner.<sup>91</sup>
3. **Corporation-Shareholder**—These are loans from a corporation to a shareholder of the corporation or from a shareholder to a corporation. Loans to shareholders who are also employees are considered shareholder loans if certain minimal stock ownership requirements are met.<sup>92</sup>
4. **Tax Avoidance**—These are loans in which one of the principal purposes for the interest arrangement is avoidance of federal tax by the borrower or lender or both.<sup>93</sup>
5. **Tax Effect Loans**—These are loans that have a significant effect on the tax liability of the lender or borrower as defined by IRS regulations. The IRS has not yet issued regulations under this provision.

Gift loans, compensation loans, and shareholder-corporation loans are considered in more detail below. Keep in mind that the rules of Code Sec. 7872 for interest-free and below-market rate loans generally do not apply to any loan given in consideration for the sale or exchange of property and covered by the original issue discount rules or paid on account of the sale or exchange of property and covered by the imputed

<sup>89</sup> Code Sec. 7872(f)(2).

<sup>90</sup> Code Sec. 7872(c).

<sup>91</sup> Prop. Reg. § 1.7872-4(c).

<sup>92</sup> Prop. Reg. § 1.7872-4(d).

<sup>93</sup> Prop. Reg. § 1.7872-4(e).

interest rules.<sup>94</sup> (The original issue discount rules and imputed interest rules governing deferred payment sales of property are separately considered later in this chapter.)

### ¶ 327.1 *Gift Loans*

An interest-free or below-market rate gift loan has both income and gift tax consequences. The same rules apply to the income tax treatment of both term loans and demand loans, but the gift tax treatment differs depending on whether a gift loan is a term loan or a demand loan.

#### *Income Tax Treatment*

In the case of a gift loan, the lender is treated as transferring to the borrower an amount equal to the interest foregone by the lender (the gift). The borrower, then, is treated as retransferring an equal amount back to the lender as interest. These transfers are considered to take place on the last day of the calendar year for loans outstanding for any period during the calendar year. Foregone interest is the difference between what would have been payable on the loan if interest accrued at the applicable federal rate and was paid on the last day of the calendar year and any interest actually payable on the loan allocable to the same period.

For the borrower, the amount of interest treated as transferred to the lender is subject to all the rules that govern the deductibility of interest. If the debt may be traced to a trade or business, the interest would be fully deductible. If the debt were traced to an investment, passive activity, or personal use, the interest deduction would be limited by the various provisions that apply to interest. For the lender, the interest received is, of course, gross income under Code Sec. 61.

The application of Code Sec. 7872 is limited in certain cases involving gift loans between individuals:

1. The rules do not apply to gift loans of \$10,000 or less, as long as the loan is not used directly or indirectly to purchase or carry income producing assets.<sup>95</sup>
2. If gift loans between the parties do not exceed a total of \$100,000 and one of the principal purposes of the loan arrangement is not the avoidance of federal income tax, then the interest treated as paid by the borrower is limited to the borrower's net investment income for the year (net investment income is the same as net investment income under the investment interest limitations discussed above). If the borrower's net investment income does not exceed \$1,000, then it is

<sup>94</sup> Code Sec. 1274(c)(1); Code Sec. 483(c)(1); Prop. Reg. § 1.7872-2(a)(2)(ii).

<sup>95</sup> Code Sec. 7872(c)(2).

treated as zero. In other words, if the borrower has under \$1,000 net investment income, there is no deemed transfer of interest between the parties on a gift loan of \$100,000 or less.<sup>96</sup>

### *Gift Tax Treatment*

The gift tax treatment of a demand gift loan follows the income tax treatment. The amount of foregone interest that the lender treats as a gift to the borrower is the amount determined using the short-term federal rate on the last day of the calendar year. This means that, in the case of a demand loan that remains outstanding, a new gift is made each year equal to the foregone interest for the year.

If the gift loan is a term loan, however, the lender is treated as having made a gift of the interest on the date the loan is made. The amount of the gift is equal to the difference between the amount loaned and the present value of all payments that the borrower is required to make under the terms of the loan. Rather than a potential for a gift each year the loan remains outstanding, as is the case with a demand loan, a term loan generates but a single gift at the time of the loan.

The following example illustrates the difference between the income tax treatment and the gift tax treatment of term and demand loans under Code Sec. 7872 and is taken from the Conference Committee Report on the Tax Reform Act of 1984.

***Comprehensive Example:*** On January 1, the Father, a calendar year taxpayer, makes a \$200,000 loan to the Son, also a calendar year taxpayer. The loan is repayable in two years, with five percent simple interest payable annually.

Assuming that the applicable federal rate is 12 percent compounded semiannually, the amount of the gift made by the Father is \$24,760. This is the difference between the \$200,000 transferred to the Son and the present value at 12 percent of the \$10,000 interest payment due at the end of year one and the \$10,000 interest payment and \$200,000 principal payment due at the end of year two.

The amount treated as retransferred by the Son to the Father on the last day of each of the two calendar years is \$14,720. This is the difference between interest computed at the applicable federal rate and the interest actually payable on the loan. This amount, in addition to the \$10,000 interest called for by the loan agreement, is included in income by the Father and, subject to the rules that govern the interest deduction, is treated as interest paid by the Son.

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<sup>96</sup> Code Sec. 7872(d)(1).

### ¶ 327.2 *Compensation Loans*

In the case of compensation-related interest-free or below-market rate loans, the treatment of the employer and employee or independent contractor depend on whether the loan is a demand loan or a term loan.

#### *Demand Loans*

When an employer makes an interest-free or below-market rate demand loan to an employee or independent contractor, the employer is considered to have paid compensation or wages equal to the amount of the foregone interest for any day that the loan is outstanding. The employee is considered to have received an equal amount of compensation income. The employee, in turn, is considered to retransfer an equal amount back to the employer as interest on the loan and the employer has interest income equal to the same amount.<sup>97</sup>

For the employer, an interest-free or below-market rate demand loan to an employee generally results in a wash as far as the tax consequences are concerned. The employer reports interest income from the loan, but is entitled to an equivalent deduction for the compensation deemed paid to the employee (provided the employee's compensation meets the usual "reasonable" requirement for deduction). For the employee, the interest foregone by the employer is compensation income, subject to FICA and FUTA taxes (but not income tax withholding). The equivalent amount deemed paid as interest back to the employer may or may not produce a tax deduction, depending on the use of the loan proceeds and the usual limits on the deduction of interest paid.

#### *Term Loans*

If a compensation-related loan is a term loan, the employee is treated as receiving compensation from the employer equal to the difference between the amount of the loan and the present value at the applicable federal rate of all payments that the employee is required to make under the terms of the loan. The employee must report this full amount of extra compensation as of the date the loan was received. The employee, however, is treated as making interest payments over the term of the loan.<sup>98</sup> In this case, even if the interest is deductible, the employee will not be able to fully offset the extra compensation received on the date of the term loan.

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<sup>97</sup> Code Sec. 7872(a).

<sup>98</sup> Code Sec. 7872(b).

For the employer, the situation is reversed. The full amount of the foregone interest is deductible (assuming “reasonableness”) when the loan is made, but additional interest income is reported over the term of the loan. Considering the harsh impact a term loan can have on the employee an employer is trying to benefit, the employer can structure a term loan to have it treated as a demand loan by making the benefits of the interest rate nontransferable and conditioning them on the performance of substantial future services by the employee.<sup>99</sup>

### *De Minimis Exception*

The rules of Code Sec. 7872 do not apply to compensation-related loans if the loans to an employee do not exceed \$10,000 and do not have a principal purpose of tax avoidance.<sup>100</sup> In other words, an employee receiving an interest-free or below-market rate compensation loan of \$10,000 or less reports no income and has no possible interest deduction as a result of the loan. Similarly, the employer is not considered to be paying additional compensation and reports no interest income (other than interest actually paid by the employee).

### *Employee Relocation Loans*

Certain loans to employees are excepted from the interest-free and below-market rate loan rules of Code Sec. 7872 if they are to provide mortgage financing for an employee’s new residence or bridge financing in connection with the transfer of the employee to a new principal place of work.<sup>101</sup>

## ¶ 327.3 *Corporation-Shareholder Loans*

Interest-free and below-market rate loans between corporations and their shareholders are subject to essentially the same rules as compensation-related loans. The same distinction exists between term and demand loans, and the same \$10,000 de minimis exception applies. The difference, of course, is the nature of the deemed payments equal to the foregone interest.

In the case of a loan from a corporation to a shareholder, the amount equal to the foregone interest transferred to the shareholder represents a dividend, not deductible by the corporation but taxable to the shareholder. The interest transferred back to the corporation from the shareholder is income to the corporation and is treated as interest paid by the shareholder, subject to the usual limits on the interest deduction. Since the corporation may not deduct dividends paid, and the corporation is taxed on the interest deemed received from the

<sup>99</sup> Prop. Reg. § 1.7872-10(a)(5).

<sup>100</sup> Code Sec. 7872(c)(3).

<sup>101</sup> Temp. Reg. § 1.7872-5T(c).

shareholder, an interest-free or below-market rate loan to a shareholder may be quite costly to the corporation.

In the case of an interest-free or below-market rate loan from a shareholder to the corporation, the amount of foregone interest deemed transferred to the corporation is treated as a contribution to capital, which is not income to the corporation and not deductible by the shareholder. The amount of the contribution to capital, however, does increase the shareholder's basis for the interest in the corporation. The interest payment transferred back to the shareholder from the corporation is deductible by the corporation and income to the shareholder.

#### **¶ 327.4 Reporting Requirements**

A lender must attach a statement to the lender's income tax return for any taxable year in which the lender either has interest income or claims a deduction for an amount deemed transferred to a borrower under Code Sec. 7872. Similarly, a borrower must attach a statement to the borrower's return for any taxable year in which the borrower either has income from an imputed transfer or claims a deduction for interest under Code Sec. 7872.<sup>102</sup>

An individual who wants to take advantage of the provision that limits interest under Code Sec. 7872 to net investment income, in the case of gift loans totaling \$100,000 or less, must notify the lender in a signed statement of the amount of the borrower's net investment income.<sup>103</sup>

#### **¶ 331 ORIGINAL ISSUE DISCOUNT AND IMPUTED INTEREST ON DEFERRED PAYMENT SALES**

In many cases, the sale of real estate does not involve outside third-party financing. Rather, the seller will provide financing and accept the buyer's debt in exchange for all or a part of the purchase price. Even when third-party financing is available, it may not be sufficient. In this case too, seller financing may be made available to the buyer to make up the difference. (Installment sales and seller-financed sales of real estate are considered in Chapter 14. Here we are concerned with the tax rules governing the financing of the transaction, rather than the sales transaction itself.)

On an installment or deferred payment sale of real estate, if the buyer and seller fail to provide adequate interest on the deferred payments, one of two Internal Revenue Code provisions may come into play to rewrite the parties' financing agreement for tax purposes. These

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<sup>102</sup> The exact contents of these statements are detailed in Prop. Reg. § 1.7872-11(g).

<sup>103</sup> Prop. Reg. § 1.7872-11(g)(3).

provisions are the imputed interest rules of Code Sec. 483 and the original issue discount rules of Code Sec. 1274.

Before 1985, there was only one provision to deal with, the imputed interest rules of Code Sec. 483. In the Tax Reform Act of 1984, however, Congress expanded the original issue discount (OID) rules to cover many deferred payment sales of property. Previously, the OID rules were limited generally to publicly traded debt instruments and debt issued for publicly traded property.

The imputed interest rules were enacted in 1964 to close what was then perceived as a loophole in the tax law. At that time, an individual could convert what would be ordinary income into capital gain on the sale of a capital asset for installment or deferred payments. The strategy was simple. Instead of charging interest on the deferred payments, the seller would simply charge a higher price for the asset. The higher price, of course, was to compensate the seller for the interest the seller would otherwise receive. The buyer would pay no more than if the buyer paid a lower price plus interest, but the seller was able to report capital gain, which was subject to preferential tax treatment at that time, rather than ordinary interest income.

The imputed interest rules of Code Sec. 483 limited this strategy to convert ordinary income into capital gain by “imputing” interest in a contract for the sale of property unless a statutorily set minimum rate of interest was called for by the agreement. Since the fixed interest rate called for under the imputed interest rules did not always reflect current interest rates, Congress made the imputed interest rate under Code Sec. 483 conform to the OID rates when the OID rules were expanded in 1984 (how the rates are determined is discussed below for both the imputed interest rules and the OID rules).

While the imputed interest rules could block the conversion of ordinary income to capital gain as outlined above, Code Sec. 483 still left another loophole. If a cash basis seller sold an asset to an accrual basis buyer in an installment or deferred payment sale, a tax shelter of sorts could be constructed by manipulating the timing of the interest payments on the deferred amounts. The buyer could accrue and deduct the interest for the periods to which it related, even if the interest was not actually paid. The seller, however, would not have to report interest income until interest payments were actually received. In short, it was possible to generate an interest deduction for one taxpayer without a corresponding amount of interest income for another taxpayer. It is this second loophole, along with the conversion loophole, that the OID rules of Code Sec. 1274 are designed to close.

Unlike the imputed interest rules, the OID rules do more than merely convert “principal” into interest for tax purposes when insufficient interest is called for by the parties to a sale of property. The OID rules also require both the buyer and seller to account for any OID on an economic accrual basis by which OID is deemed to accrue at the applicable statutory rate with six-month compounding. Also, even if there is sufficient interest called for in a sale contract, the OID rules may require that the parties account for that interest for tax purposes under the OID accrual rule. (There is an exception that allows cash basis accounting in certain cases, and this is discussed in connection with the OID rules at ¶ 335.1.) In short, in addition to preventing the conversion of interest income into capital gain, the OID rules also match the buyer’s interest deduction and the seller’s interest income, regardless of their actual accounting methods and regardless of when interest payments are actually made.

*Note:* In 1986, the IRS issued proposed regulations that took up over 400 pages of typewritten copy and proposed additions or changes to the regulations under Code Secs. 163(e), 446, 482, 483, 1271, 1272, 1273, 1274, 1274A, and 1275. In 1992, the IRS withdrew most of those proposed regulations and issued new proposed regulations on the OID rules under Code Sec. 163(e) and Code Secs. 1271 through 1275, and proposed amendments to the Code Secs. 483, 1001, and 1012 regulations. The 1992 proposed regulations, with some changes, were adopted as final regulations on February 2, 1994.<sup>104</sup> Appropriate citations to the final regulations are made in the following discussion. The regulations also contain additional explanations and examples on how to determine imputed interest and original issue discount and how to accrue interest under the OID rules. The discussion here concentrates on the general concepts behind imputed interest and OID rather than any detailed mathematical computations. The reader who desires to delve into the mathematical intricacies is referred to the regulations.

### ¶ 333 Imputed Interest

The imputed interest rules of Code Sec. 483 apply to an installment or deferred payment sale only if the OID rules of Code Sec. 1274 discussed below do not apply.<sup>105</sup> The real estate sales transactions that are not subject to the OID rules and, therefore, that are subject to the imputed interest rules are:

1. Sales of farms by individuals or small businesses (as defined by Code Sec. 1244(c)(3)), if the sales price of the farm is \$1,000,000 or less.<sup>106</sup>

<sup>104</sup> T.D. 8517, 59 F.R. 4799-4831.

<sup>105</sup> Code Sec. 483(d)(1).

<sup>106</sup> Code Sec. 1274(c)(3)(A).

2. Sales by individuals of their principal residences.<sup>107</sup>
3. Sales of property if the aggregate amount of debt payments and other consideration for the sale does not exceed \$250,000.<sup>108</sup>
4. Sales of land between certain family members if the sales price does not exceed \$500,000.<sup>109</sup>

### ¶ 333.1 *Unstated Interest*

Interest is imputed under Code Sec. 483 to a payment under a contract for the sale or exchange of property if the sales price is more than \$3,000<sup>110</sup> and if the following conditions are met:

1. The payment is due more than six months after the date of the sale or exchange;
2. Some or all of the payments called for by the contract are due more than one year after the sale or exchange; and
3. There is "unstated interest."<sup>111</sup>

There is unstated interest in a contract of sale to the extent the sum of the payments due under the contract exceed the present values of the payments plus the present values of any interest payments due under the contract.<sup>112</sup> Present values are calculated using a discount rate that is equal to the applicable federal rate (see ¶ 337). In the case of a sale-leaseback transaction in which the seller or related party leases a portion of the property after the sale, however, 110 percent of the applicable federal rate is used (sale-leasebacks as financing tools are discussed at ¶ 341).

Under this rule, a contract that specifies interest equal to the applicable federal rate cannot have unstated interest and cannot be subject to the imputed interest rules. To the extent that there is unstated interest, however, the unstated interest is imputed to the contract and treated as interest for all tax purposes. This also reduces the amount of principal. Accordingly, the imputation of interest under Code Sec. 483 not only produces interest income for the seller and a possible interest deduction for the buyer, it also reduces the amount realized by the seller from the sale and reduces the buyer's cost basis in the property.

### ¶ 333.2 *Land Sales Between Family Members*

In the case of a sale of land between family members for \$500,000 or less, the discount rate used to determine if there is unstated interest

<sup>107</sup> Code Sec. 1274(c)(3)(B).

<sup>108</sup> Code Sec. 1274(c)(3)(C).

<sup>109</sup> Code Secs. 1274(c)(3)(F) and 483(e).

<sup>110</sup> Code Sec. 483(d)(2).

<sup>111</sup> Code Sec. 483(c).

<sup>112</sup> Code Sec. 483(b).

is set at a maximum of six percent compounded semiannually.<sup>113</sup> Of course, this also means that the related parties may use this rate if it is lower than the applicable federal rate and avoid the imputed interest rules.

While the statute speaks to the sales price in applying the \$500,000 limitation, the proposed regulations look to the amount of the debt instrument. Reg. § 1.483-3(b)(2) provides that the special imputed interest rate applies to a debt instrument issued in a sale or exchange of land by an individual to a member of the individual's family if:

1. The individuals are the only parties to the debt instrument;
2. The debt instrument is not given in consideration for any property other than land (the exception does not apply to the sale of depreciable structures or improvements); and
3. The stated principal amount of the debt instrument, when added to the aggregate stated principal amount of any other debt instruments to which the exception applies and which were issued in prior qualified land sales between the individuals during the same calendar year, does not exceed \$500,000.

If the property sold or exchanged does include property other than land, the maximum six percent rate 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.<sup>114</sup>

Apparently, the regulations take the sensible position that sales for more than \$500,000 can be fragmented so that the \$500,000 limitation should be construed as applying to the debt. Presumably, the sales price may exceed \$500,000, and even the amount of the sales price that is financed may exceed \$500,000, but only \$500,000 is eligible for the maximum six percent imputed interest rate.<sup>115</sup>

Family members eligible for the maximum six percent imputed interest rate on the sale of land are defined by Reg. § 1.483-3(b)(2)(i) to include only an individual's brother and sister (by the whole or half blood), spouse, parents, grandparents, children and grandchildren. Full effect is given to a legal adoption in determining these relationships.

### ¶ 335 Original Issue Discount

Generally, the OID rules of Code Sec. 1274 may apply to any sale or exchange of property that is not one of the exceptions listed at ¶ 333 as covered by the imputed interest rules. If the sale of property is one

<sup>113</sup> Code Sec. 483(e).

<sup>114</sup> Reg. § 1.483-3(b)(2)(iii)

<sup>115</sup> See the examples in Reg. § 1.483-4(b)(3).

that may be covered by the OID rules, the rules apply unless the contract of sale calls for interest at the applicable federal rate and the interest is payable currently at a constant rate over its term. If either inadequate interest is called for by the contract or adequate interest is not currently payable, the OID rules apply.<sup>116</sup>

If the interest rate called for by the contract is adequate but interest is not payable currently, the OID rules force the purchaser and seller to report the interest for tax purposes based on an economic accrual of interest with six-month compounding. If interest is less than the applicable federal rate, than an imputed principal amount is calculated by discounting all payments called for by the contract at the applicable federal rate. The difference between the stated principal amount and the imputed principal amount is original issue discount and is treated as interest for tax purposes. The parties account for the OID as if interest on the imputed principal amount were being compounded at six-month intervals.

**Example:** In a sale subject to the OID rules, the Buyer and the Seller agree to a purchase price of \$1,500,000 for commercial property. The Seller agrees to accept \$500,000 in cash and the Buyer's note and purchase-money mortgage for \$1,000,000. The mortgage calls for five percent interest payable annually with the full amount of principal due at the end of five years, or payments by the Buyer to the Seller of \$50,000 each year for four years and a final payment after five years of \$1,050,000. At the time of the sale, the applicable federal rate that applies to this transaction is eight percent.

Since this deferred payment sale does not provide for adequate interest, an "imputed principal" amount and the original issue discount must be determined by discounting the payments required by the mortgage at eight percent compounded semiannually. Discounting the expected payments over the five-year term of the mortgage at eight percent gives a present value of \$880,230, and this is the imputed principal amount. Subtracting the imputed principal from the stated principal (\$1,000,000 - \$880,230) yields original issue discount in the amount of \$119,770.

The original issue discount of \$119,770 must be treated as interest for tax purposes by both the Buyer and the Seller, so the Seller reports the appropriate portion of the OID as additional interest income each year, and the Buyer may deduct an equal amount as interest, subject to the usual limitations on the deduction of interest. Also, the imputed principal amount is treated as

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<sup>116</sup> Code Sec. 1274(c).

the principal amount of the debt for tax purposes. Accordingly, the Seller's gain or loss is determined based on his amount realized of \$1,380,230 (\$500,000 cash plus \$880,230 mortgage debt), and the Buyer's cost basis for the property is also \$1,380,230.<sup>117</sup>

### ¶ 335.1 *Cash Method Accounting*

Generally, for purposes of the OID rules, any original issue discount must be treated by the parties to the transaction on an economic accrual basis regardless of their actual tax accounting methods and regardless of when interest is actually paid. There is, however, an exception to the OID accrual rule which permits the parties to elect cash method accounting for OID that would otherwise be subject to Code Sec. 1274, if certain requirements are met.<sup>118</sup> Cash method accounting is available if:

1. The stated principal amount of the debt does not exceed \$2,000,000;
2. The seller/lender does not use an accrual method of accounting for tax purposes;
3. The seller/lender is not a dealer in the property sold or exchanged; and
4. The election<sup>119</sup> to use the cash method is made jointly by both the buyer and seller.

If a debt instrument subject to a cash method election is transferred by the lender or assumed by a successor to the borrower, the election applies to the new party or parties. If a seller/lender's transferee is an accrual basis taxpayer, however, the cash method election does not apply and the transferee must use accrual accounting under the rules of Code Sec. 1272 to report any OID.<sup>120</sup>

### ¶ 335.2 *Assumptions and Modifications of Debt Instruments*

Neither the OID rules of Code Sec. 1274 nor the imputed interest rules of Code Sec. 483 apply on the assumption of an existing debt instrument unless the terms and conditions of the debt instrument are modified or the nature of the transaction is changed in connection with the assumption.<sup>121</sup>

**Example:** On the sale of property, the Seller provides a \$3,000,000 purchase-money mortgage which calls for annual interest at 15 percent. Three years later, the property is resold and the new Buyer assumes the existing purchase-money mortgage, but the

<sup>117</sup> For many additional examples relating to OID calculations, including the calculation of the amount of OID that is reported for any year over the term of the loan, see the regulations under Code Sec. 1274.

<sup>118</sup> Code Sec. 1274A(c).

<sup>119</sup> Reg. § 1.1274A-1(c)(1).

<sup>120</sup> Reg. § 1.1274A-1(c)(2).

<sup>121</sup> Code Sec. 1274(c)(4).

Seller agrees to lower the interest rate on the mortgage to nine percent. Because the mortgage debt has been modified on the assumption, the modified debt is treated as a new debt provided by the Seller in consideration for the old debt.

If the lender and borrower, or successors to either, modify a debt instrument materially either in kind or in extent, the modified debt instrument is treated as a new debt given in consideration for the old, unmodified debt. The new debt instrument is eligible for the cash method election (§ 335.1) if the other requirements are met. The new debt instrument is not eligible for the cash method election, however, if a principal purpose of the debt modification is to defer interest income or deductions through the election.<sup>122</sup>

### ¶ 337 Interest Rates Under the Imputed Interest and OID Rules

The interest rates, called federal rates, on which imputed interest or OID is determined are keyed to the interest rate on United States government obligations and the terms of the deferred payment sale.<sup>123</sup> The rates are adjusted each month based on the average market yield on outstanding government obligations and announced by the IRS. The rate for a particular sale or exchange is the rate in effect on the date of the transaction.

The applicable federal rate as announced by the IRS is determined by the term of the deferred payment obligation. If the term is three years or less, the applicable federal rate is the announced federal short-term rate. If the term is more than three years but not more than nine years, the applicable federal rate is the federal mid-term rate; and for terms in excess of nine years, the federal long-term rate is used.

Note that in the case of a sale-leaseback transaction involving seller financing, the applicable federal rates are 110 percent of the announced federal rates.<sup>124</sup>

To prevent taxpayers' planning of the sale or purchase of property from being adversely affected by monthly changes in the federal rates, a special rule permits the use of the federal rates announced for one month in the following two months as well.<sup>125</sup> The test rate generally is the lowest of the applicable federal rates in effect during either the three-month period that ends with the first month in which there is a binding written contract that contains the terms of the sale or exchange, or the three-month period that ends with the month in which the sale or exchange occurs.<sup>126</sup> For instance, a real estate sale that

<sup>122</sup> Reg. § 1.1274A-1(c)(3).

<sup>123</sup> Code Sec. 1274(d).

<sup>124</sup> Code Sec. 1274(e).

<sup>125</sup> Code Sec. 1274(d)(2).

<sup>126</sup> Reg. § 1.1274-4(a)(1).

closes in April may test for imputed interest or OID using the lowest federal rates announced for February, March, or April.

### ¶ 337.1 *Maximum Interest Rate*

If seller financing or other debt subject to the imputed interest or OID rules does not exceed \$2,800,000, the maximum rate under the imputed interest or OID rules is nine percent.<sup>127</sup> This rate is merely a maximum. If the applicable federal rate announced by the IRS for the month of sale (or preceding two months) is lower, the lower rate may be used in place of the nine percent rate. The maximum nine percent rate generally does not apply to new tangible personal property.<sup>128</sup>

### ¶ 337.2 *Installment Obligations*

In the case of an installment obligation, the term of the instrument is the instrument's weighted average maturity as defined in Reg. § 1.1273-1(e)(3).<sup>129</sup>

### ¶ 337.3 *Variable Interest Rate Obligations*

Generally, for purposes of determining whether there is adequate interest, a variable rate debt keyed to an objective index (such as prime, federal rate, LIBOR, or average yield on treasuries) is treated as if the debt called for a fixed rate equal to the variable rate at the time the debt is tested for adequate interest.<sup>130</sup>

The general rule for variable rate obligations does not apply if, as a result of interest rate restrictions, such as an interest rate cap, the expected yield of the obligation taking the restrictions into account is significantly less than the expected yield of the obligation without regard to the restrictions. In this case, the interest payments on the obligation, other than any fixed interest payments, are treated as contingent payments.<sup>131</sup> An obligation is not subject to this rule if it contains reasonably symmetric interest rate caps and floors, or reasonably symmetric governors, that are fixed throughout the term of the obligation.

**Example:** A sells B property and as part of the consideration, B gives A a note for \$1,000,000 payable in five years. Interest is payable monthly at a rate equal to one percentage point above the prime rate for the preceding month. If the applicable federal rate for this debt were 7.5 percent, and if, on the date this test rate is determined, the prime rate plus one percent equalled nine percent, the debt would have adequate interest.<sup>132</sup>

<sup>127</sup> Code Sec. 1274A(a).

<sup>128</sup> Code Sec. 1274A(b).

<sup>129</sup> Reg. § 1.1274-4(c)(1).

<sup>130</sup> Reg. § 1.1274-2(f)(1).

<sup>131</sup> Reg. § 1.1274-2(f)(1)(ii).

<sup>132</sup> For additional examples, see Prop. Reg. § 1.1274-3(d)(1)(v).

**¶ 337.4 Contingent Interest**

If a debt instrument provides for one or more contingent payments, the issue price of the debt instrument is the lesser of the instrument's noncontingent principal payments and the sum of the present values of the noncontingent payments determined under Reg. § 1.1274-2(c). If the debt instrument is issued in a potentially abusive situation, however, the issue price is the fair market value of the noncontingent payments.<sup>133</sup>

When an obligation containing contingent payments is subject to Code Sec. 1274, any noncontingent payments are treated as a separate debt instrument. The issue price of the overall debt instrument is determined as above (Reg. § 1.1274-2(g)).<sup>134</sup>

A contingent payment is treated as a payment of principal to the extent of the present value of the payment, determined by discounting the payment at the test rate from the date of the payment is made to the issue date. Any amount in excess of part of the payment treated as principal is interest.<sup>135</sup> The test rate is the rate that would be the test rate for the overall debt instrument if the term of the overall debt instrument began on the issue date and ended when the contingent payment is made. In the case of a contingent payment that consists of a payment of stated principal accompanied by a payment of stated interest at a rate that exceeds this test rate, however, the test rate is the stated interest rate.<sup>136</sup>

**Example:** On January 1, 1997, A sells a newly constructed office building to B for a \$1,000,000 in cash and a debt instrument that matures on December 31, 2001. The debt instrument provides for a payment at maturity of \$5,000,000 and a contingent payment of interest on December 31 of each year equal to a fixed percentage of the gross rents B receives from the building in that year. On January 1, 1997, the short-term applicable federal rate is 5 percent, compounded annually, and the mid-term rate is 6 percent, compounded annually.

The issue price of the debt instrument, determined under the rules of Reg. § 1.1274-2(g) is \$3,736,291—the present value of the \$5,000,000 noncontingent payment due on December 31, 2001, based on a discount rate equal to the mid-term applicable federal rate of 6 percent. (B's basis in the building is \$4,736,291, the \$1,000,000 cash plus the present value of the noncontingent payment.) The noncontingent payment is treated as a separate debt

<sup>133</sup> Reg. § 1.1274-2(g).

<sup>134</sup> Reg. § 1.1275-4(c)(3).

<sup>135</sup> Reg. § 1.1275-4(c)(4)(ii).

<sup>136</sup> Reg. § 1.1275-4(c)(4)(ii)(B).

instrument with an issue price of \$3,736,291 and OID of \$1,263,709.

If the contingent payment that is fixed and payable on December 31, 1997, is \$200,000, the present value of that amount discounted at the short-term federal rate of 5 percent from the date the payment is made to the issue date, or \$190,476, is principal, and the remainder of \$9,524 is interest. (The amount treated as principal increases B's basis in the building.) The remaining contingent payments are accounted for in a similar fashion—discounted at 5 percent for the payments due at the end of 1998 and 1999, and discounted at 6 percent for the contingent payments due at the end of 2000 and 2001.<sup>137</sup>

### ¶ 337.5 *Excessive Interest*

The imputed interest and OID rules generally set the minimum interest rate that can be charged for tax purposes in a contract for the sale of property. But what about a maximum rate of interest? May a buyer and seller lower the purchase price and charge a higher rate of interest to provide a tax advantage for one of the parties? Corporations that issue certain "high yield" discount obligations may lose a portion of their interest deductions, but what of other taxpayers?

As discussed at ¶ 105.3, the IRS does have the power under Code Sec. 1274(b)(3) to limit the imputed principal amount of a debt instrument to the fair market value of the property acquired with the debt, and this power would seem to apply equally to a reduced purchase price to gain a tax advantage from interest deductions as to an inflated purchase price to gain depreciation or other tax advantages. Reg. § 1.1274-2(b)(3) specifically provides that in the case of a debt instrument issued in a potentially abusive situation, the issue price of the debt instrument is the fair market value of the property received in exchange for the debt instrument, reduced by the fair market value of any consideration other than the debt. An abusive situation includes a debt instrument with clearly excessive interest.<sup>138</sup> According to the regulations, 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 persons.<sup>139</sup>

<sup>137</sup> For additional examples, see Reg. § 1.1275-4(e)(7).

<sup>138</sup> Reg. § 1.1274-3(a)(2)(iv).

<sup>139</sup> Reg. § 1.1274-3(b)(3).

### ¶ 341 SALE-LEASEBACKS AND OTHER LEASE FINANCING

From a practical point of view, there may be very little difference between outright ownership of property and a long-term lease of the property, as far as the user of business property is concerned. In many cases, leasing transactions serve as a substitute for traditional financing. In a typical sale-leaseback, the owner of property sells the property to an investor and immediately leases the property back. A sale-leaseback can be arranged with any type of property, but it is real estate that is most often the subject of a sale and leaseback. The lease in a sale-leaseback is usually a net lease that assures the investor a return over and above the cost to him of financing the purchase of the property from the seller-lessee.

Apart from sale-leasebacks, a lease of property combined with an option to purchase by the lessee may be another way, in addition to a purchase-money mortgage, for the seller of property to provide financing for the prospective purchaser of property.

### ¶ 343 Straight Sale-Leaseback

In a straight forward sale-leaseback, the owner of property sells the property to an investor. The property may be newly constructed property or property that has been owned by the seller for some time. (In some deals, the seller may be a builder or developer who has constructed the property to the specifications of the future lessee. In these cases, the sale directly to the investor party eliminates the intermediate step of having the ultimate user of the property acquire title and then selling to the investor.) The investor may or may not obtain traditional mortgage financing from an outside third-party lender in order to finance the purchase. The investor then immediately leases the property back to the seller, usually on a long-term net lease. Under this arrangement, the seller-lessee is assured of the use of the property and is responsible for all property taxes, insurance, maintenance and upkeep expenses. The purchaser-lessor, through the net lease, is provided with a guaranteed return on his investment, and ownership of the property provides him with security for his investment.

In this form, the sale-leaseback is substituting for mortgage financing. Moreover, the amount of cash that is freed for the seller-lessee may be equal to the full value of the property, the equivalent of 100 percent financing.

**Example:** A business owns a warehouse that is worth \$500,000. The business would like to free up the cash that is tied up in the land and building for other uses, but wants to continue to use the warehouse in its business operations. One avenue open to this

business is to borrow against the property by obtaining a mortgage loan for 80 percent of the property's value, or \$400,000. Instead of a mortgage loan, however, the business may want to explore a sale-leaseback that could free the entire \$500,000 value of the building.

Assuming the mortgage loan could be obtained for a 25-year term at 10 percent, the business would be obligated to pay about \$43,600 annually to amortize the loan over the 25 years. With a sale-leaseback, the business would sell the land and building to an investor for its full \$500,000 value. Under the lease of the warehouse back from the investor, the lease might be for a 25-year term with annual payments of about \$54,500, which is about the amount required to fully return the investor's \$500,000 plus 10 percent interest over the 25-year term of the lease.

While the sale-leaseback as described above does free up the full value of the real estate assets, it does have significant drawbacks. First, at the end of the lease term, the investor and not the business owns the property, and the residual value, which may be significant, belongs to the purchaser-lessor. Second, the seller-lessee may want to continue using the property at the end of the lease term, but the property now belongs to the purchaser-lessor and the lease arrangement may have to be renegotiated. For these reasons, sale-leasebacks will contain various options for repurchase of the property or for the renewal of the lease on predetermined terms. These options, however, may complicate the tax treatment of the sale-leaseback.

### ¶ 343.1 *Tax Benefits*

Provided that the sale-leaseback is recognized as a sale and a lease for tax purposes, the seller-lessee deducts the full amount of its rental payments. If there is a gain or a loss on the sale portion of the transaction, the gain or loss is taxable under the usual rules. The purchaser-lessor has income from the rents received from the seller-lessee, but this income may be sheltered by the operating expenses and depreciation deductions available to the owner of real estate.

(Lease payments are considered at ¶ 401, sales of real property at ¶ 1301, real estate operating expenses at ¶ 721, and depreciation at ¶ 901.)

For the seller-lessee, the sale-leaseback may provide a tax benefit because the deduction for rental payments may be greater than depreciation and interest deductions from traditional financing. This is more likely to be the case if the property has already been fully depreciated or if the property is leased back for less than its useful life. The sale-leaseback also may provide benefits for the seller-lessee when the seller-lessee cannot utilize the tax benefits associated with the ownership of

depreciable property. The sale to an investor who can benefit from the tax advantages of ownership may permit the seller-lessee to lease at a favorable rate, in effect, splitting the tax benefits with the investor. Whether or not a sale-leaseback will actually provide a net benefit in a given situation may require extensive projections and computations. In many cases, the disadvantages of a sale-leaseback will outweigh the benefits.

Of course, to realize the tax benefits of a sale-leaseback, the transaction must be treated as a sale and leaseback for tax purposes, rather than as a mere financing device. The guidelines that have been applied are discussed at ¶ 345. If a sale-leaseback is not recognized as such for tax purposes, but is treated as a secured loan, the consequences are substantial. Since all calculations of the potential benefits of a sale-leaseback hinge on the tax treatment, it is essential that the parties to a proposed sale-leaseback be certain of the treatment of their transaction.

If a sale-leaseback is treated as a secured loan for tax purposes, the seller-lessee would be denied deductions for rent or lease payments. The seller-lessee's payments would be treated as payments on a loan—partly interest and partly the amortization of principal. Depreciation would be available to the seller-lessee who continues to be considered the owner of the property, but the rate and method of depreciation would be the same as before the purported sale of the property. The purchaser-lessor, instead of being in the position of the owner of property, would be in the position of a mortgagee. Depreciation deductions would not be available, nor would other deductions associated with the ownership of real property. To the extent payments received represent principal, however, the purchaser-lessor's income would be reduced.

### ¶ 343.2 *Like-Kind Exchange and the Sale-Leaseback*

Real estate held as an investment or used in a trade or business may be exchanged for other investment or business real estate without recognition of gain or loss.<sup>140</sup> Reg. § 1.1031(a)-1(c) provides that no gain or loss is recognized if a taxpayer exchanges "a leasehold of a fee with 30 years or more to run for real estate." This raises the danger that if the lease in a sale-leaseback is for 30 years or more, the sale-leaseback may be treated as a like-kind exchange of property, although it is not entirely clear that this provision governs when only one property is involved, that is, when a fee interest is exchanged for a

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<sup>140</sup> Code Sec. 1031; like-kind exchanges are considered fully at ¶ 1311.

leasehold interest in the same property. There is a split of authority among the Circuit Courts of Appeals.

In *Century Electric Co.*,<sup>141</sup> the Eighth Circuit held that the sale of business property at a loss followed by a leaseback of the property for 95 years was a like-kind exchange which made the loss nondeductible. The court applied the regulation quoted above<sup>142</sup> and held it valid as applied to an exchange of a 30-year-or-longer leasehold for a fee interest, even though the rights exchanged are in the same property. On the other hand, the Second Circuit skirted the issue in *Jordan Marsh Co.*<sup>143</sup> In this case, a department store which sold the properties on which its store was operated for cash and simultaneously received a leaseback for 30 years and three days sustained a recognizable loss since, according to the court, there was in fact a sale for the full value of the properties conveyed, and not an exchange. The court found it unnecessary to pass on the validity of Reg. § 1.1031(a)-1(c) as applied to a leasehold of 30 years or more exchanged for a fee interest in the same property.<sup>144</sup> The key to sale-leaseback treatment rather than like-kind exchange treatment is that the sale must be for full fair market value and the rental must also be at fair rental value. Of course, if the term of the leaseback is less than 30 years, the problem cannot arise.

### ¶ 345 Recognition of a Sale-Leaseback for Tax Purposes

Determining whether a particular sale-leaseback will be recognized as such for tax purposes, or whether it will be treated as a mortgage financing arrangement is not an easy task. The Supreme Court has established some guidelines, and further guidance may be distilled from IRS pronouncements.

#### ¶ 345.1 Supreme Court Guidelines

In *F. Lyon Co.*,<sup>145</sup> the Supreme Court held that the purchaser-lessor in a sale-leaseback was the owner of the building and that the arrangement was not merely a financing arrangement. The seller-lessee was a bank that could not itself finance the construction of a new building because of state and federal banking restrictions. The purchaser-lessor was a home furnishing company that agreed to take title to the building as it was being constructed and to lease it back to the bank with options to repurchase at various times. The purchaser-lessor obtained both a construction loan and permanent mortgage financing,

<sup>141</sup> CA-8, 51-2 USTC ¶ 9482, 192 F.2d 155, cert. denied, 342 U.S. 954, 72 S.Ct. 625.

<sup>142</sup> Reg. § 1.1031(a)-1(c).

<sup>143</sup> CA-2, 59-2 USTC ¶ 9641, 269 F.2d 453.

<sup>144</sup> The IRS will not follow the decision in *Jordan Marsh*. See Rev. Rul. 60-43, 1960-1 CB 687. For

additional cases holding that the like-kind provisions do not apply to a genuine sale-leaseback transaction, see *Leslie Co.*, CA-3, 76-2 USTC ¶ 9553, 539 F.2d 943 and *Crowley, Milner & Co.*, CA-6, 82-2 USTC ¶ 9612, 689 F.2d 635.

<sup>145</sup> 78-1 USTC ¶ 9370, 435 U.S. 561, 98 S.Ct. 1291.

and made an initial investment of \$500,000 in the building in order to diversify its operations.

The Court held that the sale-leaseback was genuine and pointed to the following factors:

1. A genuine multi-party transaction (financing was obtained from outside sources) with economic substance took place;
2. The sale-leaseback was compelled or encouraged by business or regulatory considerations and was not merely the result of tax avoidance considerations; and
3. The lessor retained significant and genuine attributes of the traditional lessor status.

Under these guidelines, if the purchaser-lessor supplied all of the funds for the purchase of the property, that is, did not obtain outside financing, and if the seller-lessee has a repurchase option that takes away any risk born by a lessor, the transaction would be treated as a financing arrangement, rather than as a sale and a leaseback.

#### ¶ 345.2 *IRS Guidelines*

In a series of pronouncements, the IRS has established some guidelines of its own for determining whether there is a true lease or merely a financing arrangement. Although most of these pronouncements are directed to leveraged leasing of equipment, they may offer guidance by way of analogy in the case of the sale-leaseback of real estate. As distilled from Rev. Rul. 55-540,<sup>146</sup> Rev. Proc. 75-21,<sup>147</sup> Rev. Proc. 75-28,<sup>148</sup> Rev. Proc. 76-30,<sup>149</sup> and Rev. Proc. 79-48,<sup>150</sup> the IRS may characterize a lease transaction as a financed sale transaction if one of the following factors is present:

1. The lessee acquires equity through the lease payments;
2. The lessee acquires title to the property after the required number of lease payments have been made;
3. The lessee's total lease payments are due in a relatively short time, and the payments substantially cover the amount required to purchase the asset;
4. The lease payments substantially exceed the fair rental value of the property indicating that the transaction is financed over less than the life of the asset;
5. The property will be acquired by the lessee at the end of the lease term for a nominal sum;

<sup>146</sup> 1955-2 CB 39.

<sup>147</sup> 1975-1 CB 715.

<sup>148</sup> 1975-1 CB 752.

<sup>149</sup> 1976-2 CB 647.

<sup>150</sup> 1979-2 CB 529.

6. The lessee participates with the lessor in the acquisition of the asset by guaranteeing a loan or through similar agreements; or
7. The lessor has little or no at-risk investment in the property (in a leveraged equipment lease, the IRS looks for a minimum at-risk investment of 20 percent of the asset's cost).

### ¶ 347 Variations on the Sale-Leaseback

The straightforward sale-leaseback transaction may be modified in several respects to provide advantages to the parties and to accommodate various situations. The following discusses some of the more common variations.

#### ¶ 347.1 *Split Financing*

Rather than a sale and leaseback of the entire real estate package, the real estate may be split into its components and only one component made the subject of the sale-leaseback. This is commonly done with a subordinated land lease. When a building is to be constructed, the land is sold to an investor and then leased back. Traditional mortgage financing is obtained by the seller-lessee of the land for the construction of the improvements. The lease is made subordinate to the mortgage. This arrangement provides financing for the land cost of a project which is not normally available through a traditional mortgage.

The tax treatment of these split financing sale-leasebacks hinges on the same factors as a regular sale-leaseback.

#### ¶ 347.2 *Related Party Sale-Leasebacks*

Related party sale-leasebacks present problems in several respects. First, under Code Sec. 267, a loss on the sale of property to a related party is disallowed. A related party is defined to include family members, controlled corporations, and trustees. This, of course, would only be a consideration if the subject of the sale-leaseback had a value less than its basis.

Even more important, a sale-leaseback involving related parties does not fall squarely within the Supreme Court guidelines for a valid sale-leaseback, which are discussed at ¶ 345.1. There is also the danger that the sale and rental prices set by related parties will not be fair values.

Despite these problems, it is still possible to arrange a sale-leaseback between related parties, especially in light of Tax Court decisions upholding the validity of gift-leaseback transactions. A gift-leaseback is essentially the same as a sale-leaseback, except that the lessee gives the property to the lessor prior to the leaseback. In many cases, these transactions are between a property owner and a trust set

up for the benefit of the owner's children. The validity of a sale-leaseback between related parties is more likely to be upheld if the arrangement conforms to the guidelines that have been applied to gift-leasebacks. The Tax Court would also support the transaction if the sale is for less than full value, since this arrangement may be split into a part-sale, part-gift and leaseback.

According to the Tax Court, a gift-leaseback transaction is valid if the following conditions are met:

1. The donor must not retain substantially the same control over the property after the gift-leaseback transaction;
2. The lease must be in writing and call for a reasonable rent;
3. The leaseback must have a bona fide business purpose (although the Fourth and Fifth Circuit Courts seem to look for a business reason for the gift as well); and
4. The donor must not retain any equity in the property and must not have the right to regain the property.<sup>151</sup>

### ¶ 347.3 *Equity Participation*

As noted above, one of the drawbacks in a sale-leaseback for the seller-lessee is that the property may have significant residual value at the end of the lease term. To overcome this, a sale-leaseback arrangement may give the seller-lessee an option to repurchase at the end of the lease term, although this may confuse the tax treatment of the transaction. Instead of an option to repurchase, the seller-lessee may be given a chance to share in any appreciation experienced by the property after the sale to the purchaser-lessee. This avoids the repurchase option, but may create other problems since, to the extent of the equity participation, the seller-lessee has not really parted with the property.

### ¶ 347.4 *Tax-Exempt Entity Leasing*

Tax-exempt organizations and government units gain no advantage from depreciation on property that they own or use. This makes these entities prime candidates for the role of seller-lessee in a sale-leaseback. Through a sale of property to an investor followed by a leaseback, tax-exempt entities may obtain indirectly, through reduced rentals, the benefits of depreciation. For the purchaser-lessor, however, a sale-leaseback with a tax-exempt entity means reduced benefits from depreciation. For real estate leased to a tax-exempt entity, the depreciation period is generally 40 years. (Depreciation is considered in Chapter 9.)

<sup>151</sup> See *C.J. Mathews*, 61 TC 12, CCH Dec. 32,161, rev'd CA-5, 75-2 USTC ¶9734, 520 F.2d 323, cert. denied 424 U.S. 967, 96 S.Ct. 1463, and *R.A. Serbousek*, 36 TCM 479, CCH Dec. 34,353(M), T.C. Memo. 1977-105.

**¶ 349 Lease With Option as Conditional Sales Contract**

In any lease with an option to purchase, there is the danger that the IRS may view the transaction as a sales contract and the lease as a mere financing device in which the parties are attempting to gain the tax advantages of a lease while giving the lessee the right to take title to the property. In any lease arrangement with a purchase option, the parties must keep the option price high enough and the rental payments low enough so that the transaction will be treated as a lease and the rents will be deductible.

The Tax Court seems to apply an economic reality or intent to purchase test. If the option is exercisable within a period which is clearly less than the useful life of the property, and the rental payments cover a substantial part of what would be the purchase price, the Tax Court is likely to hold that a sale and purchase are intended. This was the result when a taxpayer paid \$300,000 for two years' rent on a farm and then exercised an option to buy for an additional \$100,000.<sup>152</sup>

In *M&W Gear Co.*,<sup>153</sup> the Court denied a deduction for rents. Through the purported rental payments, the taxpayer acquired a substantial equity in land. Factors the Court considered were:

1. Evidence of an initial intent to purchase by the lessee;
2. Unreasonably high rent;
3. No provision for cancellation of the lease without cause;
4. The lessee was obligated to exercise the purchase option as a matter of economics, since the lessee had made costly improvements that could not be removed and that could be retained only if the option to purchase were exercised.

On the other hand, a 10-year lease with an option to purchase real estate was a lease and not a sale, and payments under the lease were held deductible in *Calcasieu Paper Co., Inc.*<sup>154</sup> The value of the property was not in excess of the option price, only payments made in the last two years of the lease were applied to the purchase price, the amount paid on exercise of the option was 40 percent of the total payments under the lease, the option could be exercised only after a period of six years, and the parties intended to make a lease.

*WBSR, Inc.*<sup>155</sup> involved the lease of the physical properties of a radio station for one year at a rent of \$4,000 and an option to buy for \$44,000 less any rent paid. The lessee exercised the option to purchase but was entitled to a deduction for the rent paid under the agreement.

<sup>152</sup> *M. Berry*, 11 TCM 301, CCH Dec. 18,882(M).

<sup>153</sup> CA-7, 71-2 USTC ¶ 9555, 446 F.2d 841.

<sup>154</sup> 12 TCM 74, CCH Dec. 19,445(M).

<sup>155</sup> 30 TC 747, CCH Dec. 23,061, Acq. 1958-2 CB 8.

The rent was not excessive in relation to the fair market value of the property. See also *Breece Veneer & Panel Co.*,<sup>156</sup> in which an agreement to pay rent of \$100,000 in 60 monthly installments and an option to purchase for \$50,000 was held a lease and the rent payments deductible because the lessee had no equity in the property until the option was exercised.

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<sup>156</sup> CA-7, 56-1 USTC ¶9485, 232 F.2d 319.