Applying the OID Rules to an Intra-Family Promissory Note

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Unwelcome income tax consequences can be averted by preparing promissory notes that bear interest at the AFR or above, that mandate annual payment of interest, and that make sure the interest will be paid.

The use of promissory notes to provide benefits in intra-family transactions is a long-established technique. A promissory note can be used to "freeze" the value of an asset to allow future appreciation to accrue outside of the taxpayer's estate, or allow a purchaser with relatively little cash, such as a child or a trust for a child, to purchase assets from the grantor. When preparing a promissory note, most practitioners are aware that the promissory note needs to bear interest at or above the applicable federal rate (AFR), found in Section 1274(d), in order to avoid gift tax consequences under Section 7872. However, depending on how the transaction is structured, unexpected and unwelcome income tax consequences under Section 1272 and related Code Sections still can occur with a promissory note that bears interest at or above the AFR, if interest is not paid timely under the promissory note (not less frequently than annually) and is instead deferred or allowed to accrue.

HYPOTHETICAL SCENARIO

Consider the following scenario. Andy creates Acme LLC and contributes to it assets valued at $2,000,000. Andy then creates an irrevocable gift trust (Trust) for the benefit of his son Sam, makes a gift to Trust of $35,000 in cash and sells a 25% interest in Acme LLC to Trust. An appraisal determines that the fair market value of the 25% interest, after applicable discounts for minority interest, lack of control and lack of marketability is $350,000 (a total discount of 30%). Trust, lacking sufficient cash, pays for the purchased LLC interest by issuing a promissory note (Note) to Andy for $350,000, with interest at 3% compounded annually, but where all of the interest and principal, $456,670.61, is payable on maturity in nine years. Assume the mid-term AFR in the month of the sale is

3%, so the Note is not a below-market loan to which Section 7872 would apply.[1] Ignoring any valuation and gift tax reporting concerns, what income tax consequences resulting from the Note arise under Section 1272 and related Code Sections?

The original issue discount (OID) rules in the Code are varied and complex, having been enacted and revised to combat the deferral of interest income, perceived abuses and tax shelters. "Earned original issue discount serves the same function as stated interest...."[2] While primarily focused on financial instruments such as bonds and corporate debt, these rules can nonetheless affect intra-family promissory notes under certain circumstances. To analyze Section 1272, begin by looking at Section 483. Section 483 is an imputation rule, which provides that, where it applies, an amount equal to the "total unstated interest" is treated as interest.[3] Stated differently, Section 483 "establishes, for purposes of the entire tax code, whether payments under an installment sales contract contain interest hidden as principal."[4] Total unstated interest is then defined as the sum of the payments to which Section 483 applies that are due under a contract for the sale or exchange of property, reduced by the sum of the present values of such payments and the present values of any interest payments due under such contract.[5] However, Section 483 does not apply to any debt instrument (such as a promissory note) for which an "issue price" is determined under Sections 1273(b)(1)-(3) or Section 1274.[6] Other exceptions to Section 483 also apply.[7]

The issue price of a debt instrument, for purposes of Section 1273 (it is redefined elsewhere) is defined in Section 1273(b). For a non-publicly offered promissory note that is not issued for "property" (which includes services and the right to use property, but does not include money, so not issued for property translates to issued for money), the issue price is the price paid by the first buyer. For a non-publicly offered promissory note that is issued for property (such as interests in Acme LLC), unless Section 1274 applies, the issue price is the "stated redemption price at maturity," which is itself defined in Section 1273(a)(2) as meaning the "amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument)."[8] In the case of the Note, the stated redemption price at maturity is the $456,670.61 payable at maturity.

The original issue discount (OID) rules in the Code are varied and complex, having been enacted and revised to combat the deferral of interest income, perceived abuses and tax shelters.

Having looked at Section 1273 in order to understand whether Section 483 applies to the Note, the rabbit hole now leads to Section 1274. Under Section 1274(a), if Section 1274 applies, the issue price is the "stated principal amount" ($350,000 in the case of the Note) when there is "adequate interest"[9] (which exists if the stated principal amount is less than or equal to the imputed principal amount); otherwise, it is the "imputed principal amount"[10] (generally the sum of the present values of all payments due under the debt instrument).

When does Section 1274 apply? Under Section 1274(c), it generally applies to any debt instrument given in consideration for the sale or exchange of property if the stated redemption price at maturity exceeds, when there is adequate interest, the stated principal amount; otherwise, Section 1274 applies if the stated redemption price at maturity exceeds the imputed principal amount. Exceptions apply, including under Section 1274(c)(3)(C), which excepts from the application of Section 1274 sales involving total payments of $250,000 or less.[11] Also, Sec-

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1 See Non-Docketed Service Advice Review (NSAR) 08777, Vaughn #8777, for an interesting discussion of how a taxpayer structuring a promissory note with interest at the AFR, where the interest is not actually paid, may be better off than a taxpayer structuring a promissory note with interest below the AFR, where the interest is actually paid. For a discussion of the gift tax consequences of an intra-family promissory note that bears interest at less than the AFR, see the author's article "Unwrap Some 'Gift Loan' Complexities of Section 7872," 122 JTAX 274 (June 2015).

2 *Gaffney*, TCM 1997-249, quoting *Midland-Ross Corp.*, 381 U.S. 54, 15 AFTR2d 836 (1965).

3 Section 483(a).

4 *Schusterman*, 63 F.3d 986, 76 AFTR2d 95-6316 (CA-10, 1995).

5 Section 483(b).

6 Section 483(d)(1).

7 Under Section 483(d), Section 483 also does not apply when the sale price cannot exceed $3,000, with regard to the purchaser, if any amounts paid on account of the sale or exchange of property are treated as if they included interest under Section 163(b), or with regard to certain sales of patents. Also, under Reg. 1.483-1(c)(3)(i), Section 483 does not apply to any transfer of property subject to Section 1041 (relating to transfers of property between spouses or incident to divorce). The Regulations also include other specific exclusions. Note also that Section 483, based on its prefatory language, applies to the entire Code. It has been argued that (based on a prior version of the Section and Regulations with the same prefatory language) this should extend to gift taxes as well (as Reg. 1.483-3 caps the test rate of interest at 6% for certain sales of land). Most courts that have considered this argument have rejected it; see *Lundquist*, 83 AFTR2d 99-1471 (DC N.Y., 1999), *Schusterman*, *supra* note 4, *Krabbenhoft*, 939 F.2d 529, 68 AFTR2d 91-6021 (CA-8, 1991). "[O]ne must accept the proposition that Congress either intended, or else simply failed to consider, the possible 'gift tax traps' that would be created any time market rates rose above six percent." *Frazee*, 98 TC 554 (1992), citing *Krabbenhoft*. However, *Ballard*, 854 F.2d 185, 62 AFTR2d 88-5988 (CA-7, 1988), found that Section 483 applied to the entire Code and limited gift tax applicability as well as income tax applicability, though subsequently in *Cohen*, 66 AFTR2d 90-6004 (CA-7, 1990), the Seventh Circuit discussed how this applies only to installment sales contracts for the sale or exchange of property.

8 As an example, the stated redemption price at maturity would include interest due under a note when the borrower had the right to pay the interest due or allow it to accrue without further interest. See FSA 200006003, which discusses a scenario, including a note with that provision.

9 Section 1274(c)(2).

10 Section 1274(b)(1).

11 Section 1274 also does not apply to the sale of farms by individuals or small businesses for $1 million or less, the sale of a principal residence, debt instruments to which Section 1273(b)(3) applies, certain sales of patents, and sales to which Section 483(e) applies.

tion 1274A provides that, for any "qualified debt instrument" (generally a debt instrument given in consideration for the sale or exchange of property where the stated principal amount does not exceed $2,800,000) under Section 483 or Section 1274, the discount rate shall not exceed 9% compounded semi-annually.[12]

So, does Section 483 apply to the hypothetical transaction above? Under Section 1274, the stated redemption price at maturity of the Note is $456,670.61, the stated principal amount is $350,000, and the imputed principal amount of the promise to pay $456,670.61 in nine years, given a mid-term AFR of 3% (i.e. the present value), is $350,000, calculated as follows: $456,670.61 / ((1 + (0.03 / 1)) ^ 9).[13] Since the stated principal amount is equal to the imputed principal amount, there is adequate interest. Finally, since there is adequate interest, the stated redemption price at maturity exceeds the stated principal amount and none of the exceptions to the application of Section 1274 applies, Section 1274 applies to the hypothetical transaction. Under Section 1273(b)(4)(B), since Section 1274 applies, Section 1273 does not apply to determine the issue price, and similarly under Section 483(d)(2), since Section 1274 applies, Section 483 does not apply.

Since Section 1274 does apply, what income tax consequences arise under the Note? While the issue price for the Note was determined under Section 1274, Section 1273 still applies to determine whether there is OID. Under Section 1273(a), OID is defined as the excess, if any, of the stated redemption price at maturity over the issue price. The excess of $456,670.61 over $350,000 is $106,670.61, which is OID under the Note.

TREATMENT OF OID

How is OID treated? Under Section 1272(a)(1), Andy, as the holder of the Note, must include in gross income an amount equal to the sum of the daily portions of the OID for each day during the tax year in which he held the Note. The daily portion, under Section 1272(a)(3), is the "ratable portion of the increase during such accrual period in the adjusted issue price" of the Note. The adjusted issue price, defined under Reg. 1.1275-1(b)(1), is generally the issue price as of the beginning of the first accrual period, and is then increased by the amount of OID previously includable in the gross income of any holder and decreased by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest. Qualified stated interest, defined in Reg. 1.1273-1(c)(1)(i), is stated interest that is "unconditionally payable in cash or property (other than debt instruments of the issuer) or that will be constructively received under Section 451, at least annually and at a single fixed rate."[14] Since all of the interest under the Note is payable at maturity, the Note has no qualified stated interest.[15] The increase in the adjusted issue price generally then is determined as follows: ((issue price + OID previously includable in the holder's gross income – payments other than qualified stated interest) × YTM) – (sum of amounts payable as interest during that accrual period), where YTM is the yield to maturity (determined on the basis of compounding at the close of each accrual period (a six-month or shorter period[16]) and properly adjusted for the length of the accrual period). Reg. 1.1272-1 provides further guidance as to how to calculate the increase, and defines the constant yield method.[17] Under Reg. 1.1272-1(b)(1), the determination is a four-step process.

- In step one, the yield to maturity (defined as the discount rate that, when used to calculate the present value of all principal and interest payments to be made, results in an amount equal to the issue price) is calculated to at least two decimal places (as a percentage).[18]
- In step two, the accrual period is determined, the simplest being the intervals between payment dates, but the accrual period may not be longer than one year and each scheduled payment of principal and interest must occur on either the first or final day of an accrual period. "[A]ny reasonable counting convention may be used" in this determination, which includes calculating 30 days per month and 360 days per year.[19]
- In step three, the OID allocable to each accrual period is determined, which is the adjusted issue price[20] at the beginning of the accrual period multiplied by the yield of the Note, reduced by any qualified stated interest allocable to the accrual period.
- In step four, the daily portions of OID are determined by "allocating to each day in an accrual period the ratable portion of the OID allocable to the accrual period."

Of course, exceptions apply. Under Section 1272(a)(2), Section 1272(a)(1) does not apply to tax exempt obligations, U.S. savings bonds, short-term obligations (a fixed maturity date not more than one year from the date of issue), obligations issued by natural persons before 3/2/84, and loans between natural persons that are not made in the course of a trade or business of the lender and where the amount of the loan (increased by all other outstanding loans between such natural persons) does not exceed $10,000, unless tax avoidance is a principal purpose.[21] Under Regs. 1.1272-1(b)(2) and (b)(3), other exceptions apply, including where a debt instrument provides for contingent payments and certain variable rate debt instruments. Finally, under Reg. 1.1272-1(c)(5), where a debt instrument provides the holder or issuer with an unconditional option that, if exercised, requires payments to be made under an alternative payment

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schedule or schedules, an issuer or holder is deemed to exercise or not exercise the option in a manner that minimizes the yield for an issuer, or maximizes the yield for a holder, on the debt instrument.[22]

APPLICATION TO THE NOTE

Applying these rules to the Note for year one (and assuming that the Note was issued on January 1), one finds that the yield to maturity is 3% as that is the rate that, in computing the present value of all of the principal and interest payable, yields the issue price of $350,000; the accrual periods are one year (as that is the maximum length and, under the Note, no payments are due for nine years); the OID for the first year is $350,000 × 0.03 or $10,500; and the daily portion of the OID (using a 365 day year) is $10,500 × 1/365, which is $28.77, but the sum of all of the daily portions, as required under Section 1272(a)(1), is $10,500. So, in the first year, Andy has to include in gross income OID of $10,500.[23] This calculation can change from year to year. For year two, the adjusted issue price is $350,000 + $10,500, or $360,500, so the OID for year two (as there is no qualified stated interest under the Note) is $360,500 × 0.03 or $10,815. So, in the second year, Andy has to include in gross income OID of $10,815. Over the nine-year term of the note, the total OID income will be $106,670.61, as stated above. From the perspective of Trust, under Section 163(e), Trust should be able to deduct the aggregate daily portions of the OID during the tax year.[24] Of course, Trust must have sufficient taxable income to benefit from this deduction.

After determining the effect of Section 1274, next look at Section 1274A(c), which could change this analysis and conclusion. Section 1274A(c) provides that, for a "cash method debt instrument," Section 1274 shall not apply and the interest on the debt instrument is taken into account by the borrower and lender under the cash receipts and disbursements method of accounting. The definition of cash method debt instrument limits the application of this rule by requiring that (1) the stated principal amount not exceed $2,000,000, (2) the lender does not use an accrual method of accounting and is not a dealer with respect to the property sold or exchanged, (3) Section 1274 would have applied but for an election under Section 1274A(c), and (4) an election under 1274A(c) is jointly made by the borrower and lender with respect to the debt instrument.[25] More exceptions apply, namely that if the debt instrument is later transferred to a taxpayer who uses an accrual method of accounting, this rule does not apply to installments in periods after the transfer, and to prevent abuse, Section 483 applies to a cash method debt instrument "as if it included provisions similar to the provisions of section 1274(b)(3)" (which deals with fair market value in potentially abusive situations).[26] So, it would appear that Andy and Trust could make an election under Section 1274A(c)(2)(D) by jointly signing a statement, to be attached to their timely filed federal income tax returns, making the election under Section 1274A(c), and if so, the rules under Section 1274 would not apply to the Note.[27]

HYPOTHETICAL TWO

Having looked at the OID issues caused from the sale of a 25% interest in Acme LLC, would the analysis be the same if the sale had been of a 13% interest? Assuming the same discounts as before, the appraised value of a 13% interest would be $182,000, which then would be the principal amount of the Note, with total payments (including interest) of $237,468.72. This leads to a different result. Section 1274(c)(3)(C) provides that Section 1274 does not apply to sales involving total payments of $250,000 or less.

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12 Note that both Section 483 and Section 1274 have requirements that at least some payments must be due in the future, more than one year in the future under Section 483(c)(1)(A), and more than six months in the future under Section 1274(c)(1)(B). This can cause unexpected results when a sale takes place on a fixed date but payment is due at a later date. See *Estate of True*, TCM 2001-167, in which the sale of stock and partnership interests occurred as of a certain date, with payment due not more than six months later. Since the payment was to be made without interest and was due not more than six months later, Section 483 and Section 1274 did not apply, although Section 7872 did apply. Also, under Section 1274A(d)(2)(A), the $2,800,000 amount is indexed for inflation, and for 2016 is $5,664,800. See Rev. Rul. 2015-24, 2015-48 IRB 687.

13 The formula for this calculation is PV = FP / ((1 + (IR / NCPY)) ^ CP), where PV is the present value, FP is the future payment whose present value is being determined, IR is the interest rate, NCPY is the number of compounding periods per year and CP is the compounding period.

14 As an example, a promissory note (or other debt instrument) issued for $100,000, maturing in four years, and providing for interest payments of $8,000 on each anniversary date of the note has qualified stated interest of 8%. See Example 1 under Reg. 1.1273-1(f) for a more detailed example.

15 For examples of a debt instrument that is a demand note and provides that all interest is due at maturity, see Example 10 under Reg. 1.1272-1(j) and FSA 366.

16 Section 1272(a)(5).

17 The constant yield method must be used under Reg. 1.1272-1(b)(1) unless an exception applies under Reg. 1.1272-1(b)(2) or (3).

18 To convert the yield for one period (such as annual) to another period (such as semi-annual), use the following formula: new yield with new number of compounding periods per year = (1 + (old yield / old number of compounding periods per year)) ^ (old number of compounding periods per year / new number of compounding periods per year) - 1. For example, converting a 3% annual yield to a semi-annual yield results in (1 + (.03 / 1)) ^ (1 / 2) - 1 = 1.4889%. See Reg. 1.1272-1(j), Example 1.

19 Reg. 1.1272-1(b)(1)(ii).

20 As defined in Reg. 1.1275-1(b).

21 Also, for purposes of the exceptions to Section 1272 involving loans between natural persons, spouses are considered to be one person, except for loans between spouses. Section 1272(a)(2)(E)(iii), Reg. 1.1272-1(a)(2).

22 See FSA 200006003 for an example of such an option. Also, although beyond the scope of this article, bankruptcy may be another exception to the inclusion of OID in gross income under Section 1272 and the deduction for interest accrued under Section 163. See Litigation Guideline Memorandum TL-103 and Field Service Advisory 2227, Vaughn #2227.

23 Note that under Section 1273(a)(3), de minimis OID, defined as OID that is less than .25% of the stated redemption price at maturity multiplied by the number of complete years to maturity, is treated as zero. Under the Note, the de minimis amount would be an amount less than $456,670.61 x .0025 x 9, which is $10,275.11. Since the OID is not less than this amount, it is not de minimis.

24 If Trust was a grantor trust, Andy should not have to recognize the OID income, and the Trust would not deduct it. See Rev. Rul. 85-13, 1985-1 CB 184; Section 671.

25 Section 1274A(c)(2).

26 Reg. 1.1274A-1 adds additional exceptions, such as excluding a sale-leaseback transaction and certain debt instruments with contingent payments from making the election under Section 1274A.

27 See Reg. 1.1274A-1(c)(1).

If Section 1274 does not apply to the Note, one looks back to Section 1273. Under Section 1273(b)(4), for a non-publicly traded note issued for property where Section 1274 does not apply, the issue price of a debt instrument issued for property is the stated redemption price at maturity. Under Section 1273(a), OID is defined as the stated redemption price at maturity over the issue price, but as the issue price is the stated redemption price at maturity, the OID under Section 1273 should be zero.

With Section 1274 not applying and Section 1273 yielding OID of zero, return to Section 483.[28] Under Section 483, the sum of the payments due under the contract is $237,468.72 and the sum of the present values of those payments is $182,000, yielding "total unstated interest" (although under the facts of the Note, the interest is actually stated) of $55,468.72. Looking further at Section 483, in paragraph (g)(3), there is a cross reference directing one to look at Section 1275(b) for special rules for certain loans for personal use, and Section 1275 provides that Sections 1274 and 483 do not apply for a debt instrument given in consideration for the sale or exchange of "personal use property." Section 1275(b)(3) provides that personal use property is property "substantially all of the use of which by the taxpayer is not in connection with a trade or business of the taxpayer or an activity described in Section 212." Section 212 in turn provides that an individual may deduct all of the ordinary and necessary expenses paid or incurred for the production or collection of income, the management, conservation or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax.

Regardless of whether the property is considered personal use property or not, Reg. 1.483-1(a)(1) provides that Section 483 applies to a contract for the sale or exchange of property where the contract provides for one or more payments due more than one year after the date of the sale or exchange, and where the contract does not provide for "adequate stated interest." Adequate stated interest exists if the contract provides for a stated rate of interest at least equal to the test rate determined under Reg. 1.483-3 that is paid or compounded at least annually. Reg. 1.483-3 provides that it is the same test rate that would apply under Reg. 1.1274-4, which in turn provides that it is the lowest AFR during the three-month period ending with the first month in which there is a binding written contract that substantially sets forth the terms ultimately consummated or the month in which the sale or exchange occurs.[29] Under the hypothetical, both the interest rate under the Note and the AFR are 3%, so there is adequate stated interest, which is compounded annually under the Note, and thus Section 483 does not, after all, apply. Note also that Section 483 applies to treat a portion of applicable payments as interest, and as the Note does not provide for payments until maturity, there are no payments to which Section 483 may apply other than the payment on maturity. So, if neither Section 483 nor Section 1274 apply, and the OID determined under Section 1273 is zero, then, under this revised hypothetical, none of the OID rules would appear to apply.

Remember that under hypothetical two, this result occurred because the sale was for a 13% interest valued at $182,000. If the sale had been for a 14% interest, which would be valued at $196,000 (with total payments, including interest, of $255,735.54), the analysis under hypothetical one would apply since the exception to the application of Section 1274 (the $250,000 exception) would not apply.[30]

HYPOTHETICAL THREE

By this point, one might think that none of these rules matter, as practitioners would not typically structure a promissory note to defer the payment of all of the interest to maturity. Assume the same facts from hypothetical one, but where the Note provides that interest at 3% is due annually, and if the interest is not paid, it will accrue interest at the same 3% rate. "If the terms of the debt instrument do not provide the holder with the right to compel payment, they must provide for a penalty that inures directly to the benefit of the holder and that is large enough to ensure that, at the time the debt instrument is issued, it is reasonably certain that, absent insolvency, the issuer will make interest payments when due."[31] Since the Note permits the interest to be paid or accrued, the interest should not constitute qualified stated interest.[32] Under Reg. 1.1273-1(b), the stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest, so the stated redemption price at maturity of the Note is $456,670.61, the same as in hypothetical one. The balance of the analysis would be the same if the interest is not actually paid annually. If, however, the interest is paid annually when due, the increase in the adjusted issue price is increased by OID previously includable in the holder's gross income and reduced by payments other than qualified stated interest. Thus, as none of the payments of interest are qualified stated interest, the OID is zero.

CONCLUSION

The OID rules contain many complexities, exceptions, and interconnections. Preparing promissory notes that bear interest at the AFR or above, that mandate the payment of interest annually, and that insure that the interest will be paid (i.e. that the interest will be treated as qualified stated interest) can help avoid unexpected income tax consequences.

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28 Under Section 483(d)(1), since Section 483 does not apply where an issue price is determined under Section 1273(b) other than Section 1273(b)(4) or under Section 1274, and since the issue price was determined under Section 1273(b)(4), it appears that both Section 1273 and Section 483 nominally can apply at the same time.

29 See Reg. 1.1274-4(a)(1)(ii). Note that this is also the rule that allows a promissory note to use the lowest AFR during that three-month period and still satisfy the AFR rules.

30 See Section 1274(c)(3)(C).

31 Rev. Rul. 95-70, 1995-2 CB 124.

32 Under the facts in Rev. Rul. 95-70, the debt instrument in Situation 2 bore interest at 8%, and unpaid interest accrued interest at 10%. This was insufficient to ensure that interest would be paid when due.