The Miracle of Compound Interest: Interest Deferral and Discount After 1982

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Introduction

Money has a time value, generally expressed as interest. The right to $1 today is more valuable than the right to $1 one year from today, by the amount that could be earned by investing $1 for one year. If interest is not paid as it accrues, the amount to be received or paid in respect of a loan normally increases at a compound rate, reflecting the fact that, since interest received currently is available for reinvestment, interest earned but unpaid should earn interest until paid. The compounding of interest may have great cumulative impact. For example, at 15 percent interest compound annually, $100 grows to $6,621 in 30 years. At 15 percent simple interest, by contrast, $100 grows to $550 in 30 years. The difference of $6,071 is interest on accrued but unpaid interest.

In the world of business and finance, compound interest normally accrues on an “economic,” “actuarial,” or “constant interest” basis.¹ A debt obligation—or, for that matter, any predictable stream of cash flows—is valued in the financial marketplace by reference to its yield to maturity or present value. While there are elaborate variations on each of these concepts (such as an investment’s internal rate of return), they all rest on the compounding of interest.² Moreover, in valuing financial instruments, analysts do not distinguish payments denominated “interest” from those called “principal” unless the distinction has legal ramifications that may have economic effect, ramifications, for example, on prepayment, in bankruptcy, or for tax purposes. Apart from these legal considerations, the financial analysis of yield is purely mathematical: Identical payments due at the same time are valued equally.

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¹ These three terms are here used synonymously.

and payments due at different times differ in value by the amount of the compound interest earned during the deferral period.

Financial accounting generally follows the compound interest model. For example, Accounting Principles Board Opinion 12, which authorizes the "interest method" for amortizing discount and premium, defines this method as follows:

The objective of the interest method is to arrive at a periodic interest rate (including amortization) which will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the un-amortized premium or discount and expense at the beginning of each period. The difference between the periodic interest cost so calculated and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization.\(^3\)

Historically, legal concepts of interest and yield, both tax and nontax, have often not accurately reflected the economic accrual of interest. Indeed, in many cases, the time value of money has been completely ignored, or has been measured by a distorted simply interest calculus. Even where economic accrual notions have been employed, shorthand formulae (such as the "Rule of 78s" as applied to installment loans) were often adopted to facilitate calculation in the pre-electronic world.\(^4\)

Legal developments in nontax areas have moved toward more rational accounting for interest during the past decade. For example, section 107 of the Truth in Lending Act\(^5\) employs economic notions in defining the annual percentage rate on consumer loans as:

That nominal annual percentage rate which will yield a sum equal to the amount of the finance charge when it is applied to the unpaid balances of the amount financed, calculated according to the actuarial method of allocating payments made on a debt between the amount financed and the amount of the finance charge, pursuant to which a payment is applied first to the accumulated finance charge and the balance is applied to the unpaid amount financed.

A similar movement toward rational accounting for interest appears to be developing in the bankruptcy law, although the law is not yet as clearly articulated as it is in the Truth in Lending Act. Section 502(b) (2) of the Bankruptcy Code\(^6\) disallows creditors' claims "for unmatured interest." While the statute does not prescribe a method for measuring


\(^4\) For a discussion of the Rule of 78s, see infra notes and text accompanying notes 46—49.


the portion of the face amount of a discounted obligation that is disallowed as unmatured interest, the legislative history strongly implies that the determination is to be based on compound interest accruing on an economic basis. The report of the House Committee on the Judiciary explains this provision by referring to a "discounting factor" bringing claims for post-bankruptcy payment to "present value." These references are echoed in the section of the House report dealing with the valuation of claims coming out of bankruptcy. Also, a number of prospectuses relating to zero coupon debt instruments have stated that, if the debtor were to enter bankruptcy proceedings, the claim of a holder of a zero coupon security for prepetition accrued interest would probably be determined under the constant interest method.

The tax law has been slow to recognize economic accrual concepts. Under the pressure of recent events, however, there has been movement toward more rational rules in this area. The changes began with revisions of the rules for the recognition of income in respect of an obligation issued with "original issue discount," that is, an obligation whose "stated redemption price at maturity" exceeds its "issue price." These rules have undergone a series of changes since the adoption of section 1232 in 1954, the effect of which has generally been to extend its scope and bring its operative rules more into accord with financial reality.

As originally adopted, section 1232 was designed merely to assure

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\footnotesize{Paragraph (2) requires disallowance to the extent that the claim is for unmatured interest as of the date of the petition. Interest disallowed under this paragraph includes postpetition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy. For example, a claim on a $1,000 note issued the day before bankruptcy would only be allowed to the extent of the [cash] actually advanced. If the original issue discount was 10% so that the cash advanced was only $900, then notwithstanding [sic] the face amount of note, only $900 would be allowed. If $900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be pro-rated and disallowed to the extent it was for interest after the commencement of the case.}

\footnotesize{Id. at 414–15 n.6, requiring the use of "discount rate" and "present value" concepts to value the consideration received by creditors as of the effective date of a bankruptcy plan of reorganization.}

\footnotesize{See, e.g., TRANSMERICA FINANCIAL CORP., PROSPECTUS SUPPLEMENT S–6 (Aug. 18, 1982) (Zero Coupon Debentures). Other prospectuses have, however, been vaguer in their description of bankruptcy law. See, e.g., MARTIN MARIETTA CORP., PRELIMINARY PROSPECTUS 9 (March 5, 1981) (Martin Marietta Corporation 7% Debentures due March 15, 2011) (upon bankruptcy, claim limited to "that portion" of the original issue discount amortized to the commencement of bankruptcy proceedings). See also 5 COLLIER, BANKRUPTCY PRACTICE GUIDE § 88.17[2][a] (1982), which indicates that interest will accrue at "the discount rate."}
that original issue discount was characterized, in accordance with its true nature, as the equivalent of interest. Accordingly, it made original issue discount ordinary income to the holder, but did not affect the timing of its recognition. As a result, discount obligation retained tax advantages over typical interest bearing bonds since a cash method holder recognized no income until the obligation was sold or retired, even though the issuer (typically on the accrual method) claimed deductions for amortized discount prior to maturity.

In 1969, section 1232 was amended to conform the timing of discount recognition for holders and issuers by requiring that holders accrue original issue discount on a straight line basis over the life of the obligation, as issuers had historically done. Straight line amortization, however, unreasonably accelerates the recognition of discount because it accrues the same amount of discount in each year of an obligation’s life. Economically, discount accrues in ever increasing amounts because the discount accruing in latter years includes a return on previously accrued but unpaid discount.\(^{10}\) The acceleration caused by straight line amortization disadvantaged tax paying holders, but benefited issuers. In the high interest rate environment of recent years, this distortion was magnified through the issuance of zero coupon and deep discount bonds, which were generally sold to tax exempt institutions. The issuers of these obligations received interest deductions far in advance of both the related cash expenditures and the related financial accounting charges to earnings which were determined on an economic accrual model.

Congress responded to this situation by enacting, as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),\(^{11}\) new sections 1232A and 163(e) of the Code. These provisions require the accrual, as income and deduction, of the “daily portions” of original issue discount These daily portions are economic accruals.\(^{12}\) An obligation’s yield to


\(^{12}\) Sections 1232A(a)(3), (4), and (5) provide the computational mechanism as follows:

(3) Determination of daily portions.—For purposes of paragraph (1), the daily portion of the original issue discount on any bond shall be determined by allocating to each day in any bond period its ratable portion of the increase during such bond period in the adjusted issue price of the bond. For purposes of the preceding sentence, the increase in the adjusted issue price for any bond period shall be an amount equal to the excess (if any) of—

(A) the product of—

(i) the adjusted issue price of the bond at the beginning of such bond period, and
maturity is first determined using annual compounding unless the Commissioner prescribes more frequent compounding. Each year's discount amortization equals (1) the obligation's beginning balance (the issue price plus previously amortized discount) multiplied by the yield to maturity, minus (2) interest paid during such year. The discount for a year is prorated among the days of the year. The issuer deducts the daily portions for the days falling within its taxable year. The holder is taxed on the daily portions for the days he held the obligation during the year. The Commissioner is granted broad discretion to adjust these rules where the terms of a particular obligation require adjustment in order to reflect accurately the holder's income. An adjustment is appropriate, for example, for put or call options at strike prices which result in a reduction or increase in the actual, as compared with the nominal, yield to maturity.

While TEFRA substantially changed the accrual rules for discount, it left in place many of the limitations of section 1232, including provisions excluding from the ambit of the original issue discount rules (1) debt instruments issued in recapitalizations and other reorganization transactions, and (2) transactions in which nontraded debt is issued in exchange for nontraded stocks or debt or other property. Thus, the

(ii) the yield to maturity (determined on the basis of compounding at the close of each bond period), over

(B) the sum of the amounts payable as interest on such bond during such bond period.

(4) Adjusted issue price.—For purposes of this subsection, the adjusted issue price of any bond at the beginning of any bond period is the sum of—

(A) the issue price of such bond, plus

(B) the adjustments under this subsection to such issue price for all periods before the first day of such bond period.

(5) Bond period.—Except as otherwise provided in regulations prescribed by the Secretary, the term "bond period" means a 1-year period (or the shorter period to maturity) beginning on the day in the calendar year which corresponds to the date of original issue of the bond.

The Joint Committee explanation of the new provisions is as follows:

The large deductions allowed to issuers of OID bonds in the early years of a bond's term relative to deductions allowed issuers of interest-bearing bonds not issued at a discount were a substantial tax advantage to the former, an advantage that increased with the term of the bonds. The ratable OID amortization formula was adopted at a time when interest rates were considerably lower than at present and when the formula involved a much smaller distortion. The formula was significantly different from the formula which issuers use to compute interest deductions on financial statements and did not represent a proper measurement of interest costs to the issuer. There was no justification for providing what was, in effect, a tax incentive for issuing long-term OID bonds.

General Explanation, supra note 10, at 160. The Joint Committee's report contains a detailed example showing the after-tax benefits to a corporate issuer of the noneconomic acceleration of interest accrual permitted under section 1232 before TEFRA.
changes wrought by TEFRA eliminated certain distortions in the concepts relating to interest accrual, but have not fully reationalized this confused area of law. Indeed, no sooner had section 1232A been adopted, than several transactions, discussed in detail below, were designed to escape it. These debt for debt transactions, which took advantage of the reorganization exception noted above, were curbed in part by the Technical Corrections Act of 1982, but only where publicly traded debt or stock is involved.

The lesson of the history of the TEFRA and Technical Corrections Act provisions relating to discount is that the only true solution to tax-motivated interest accrual schemes is a universal rule for the accrual of interest, discount, and premium based on a uniform theory of compound interest. If the federal income tax law is to reach such a comprehensive and consistent approach to the time value of money, two interrelated problems must be addressed. First, the tax law must provide for the appropriate timing of the recovery of capital and the earning of income from a financial investment in a manner that consistently applies the concept of economic accrual of compound interest. In applying this concept, the tax law should place relatively little importance on the labels placed on future payments since the characterization of a payment as interest or principal generally has little nontax economic effect. The result should be, in general, to recognize interest income and expense annually while an instrument is outstanding equal to the yield on the instrument, as determined by the financial marketplace when the instrument is issued. Second, the tax law should require symmetry in these transactions: Regardless of accounting methods, the annual inclusion of interest income and deduction of interest expense with respect to a particular transaction should be at least roughly parallel.

The remainder of this article deals with the major areas involving financial transactions in which the tax law presently provides for

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13 See infra text accompanying notes 108–111 and 124.


15 The tax law contains, of course, a built-in asymmetry resulting from the existence of tax-exempt entities, such as state and local governments, charities, and pension trusts, that frequently are on one side of a financial transaction. That asymmetry was the key to the financial viability of zero coupon bonds prior to TEFRA. Consideration of this asymmetry, however, goes beyond the scope of this article.

16 For purposes of this article, the term “financial transactions” includes loans of money and purchases of property for deferred payments. The concepts discussed herein are readily adaptable to quasi-financial transactions, such as recognition of income and expense in connection with leases of property. The problems addressed here are also manifested in many nonfinancial transactions, for instance, the accrual and valuation of obligations to perform services in the future. See
grossly distorted results that do not reflect economic accrual of interest. The first of these involves the timing of interest recognition in connection with money loans. The particular issues focused on in this context include distinguishing between principal and interest payments, and the treatment of market discount and bond premium. The article next considers indebtedness incurred in exchange for property. The issues in this section arise principally under section 483, which treats as interest certain deferred payments made in connection with purchases of property, as well as under section 1232. This section of the article deals with several transactions designed to take advantage of the confusion in section 483 between simple and compound interest concepts, as well as a major flaw in section 483 where multiple deferred payments bearing unstated interest are involved. Also discussed in this section are recapitalization transactions in which new discount debt obligations are issued for old debt obligations. Some of these debt for debt transactions have been affected by the recently enacted Technical Corrections Act. The last section of the article analyzes that Act in detail and concludes with a proposed legislative change which we believe will largely achieve the objective of applying consistent economic accrual concepts to virtually all financial transactions.

The Measurement of Interest in Money Loans

Definition of Interest

The Internal Revenue Service, quoting the Supreme Court, has defined interest for federal income tax purposes as “the amount one has contracted to pay for the use of borrowed money,” and as the “compensation paid for the use or forbearance of money.” While the Service has had little difficulty defining interest, neither the Service nor the courts has consistently required taxpayers to allocate interest to the appropriate time periods under a yield to maturity approach. We examine here the application of the concept of yield to maturity in defining interest and principal on a simple money loan, that is, an indebtedness incurred in consideration of the receipt of money, as contrasted with indebtedness incurred to acquire property.

Although the repayment terms of money loans are as varied as business exigencies and perceived tax planning opportunities require, all

Aidinoff & Lopata, Section 461 and Accrual Method Taxpayers: The Treatment of Liabilities Arising from Obligations to be Performed in the Future, 33 Tax Law. 789 (1980). While in our view the same principles ought also to apply to nonfinancial transactions, this article focuses only on financial transactions.

money loans are permutations of three paradigmatic cases: A par bond, where interest is paid currently, and principal (consisting of a return of lent capital) is paid in one or several maturity payments; a discount obligation, where interest is not paid in full currently and accumulated interest and principal are paid together in one or more maturity payments; and an installment loan (or annuity), where current payments regularly exceed interest on the debt and amortize the principal of the debt by maturity.\textsuperscript{18} TEFRA's amendments introducing the concept of the economic accrual of interest to original issue discount obligations have already been summarized above. The remainder of this section considers several areas in which economic accrual concepts are applied or ignored in connection with bonds and installment loans.

**Distinguishing Between Principal and Interest on a Bond**

**Par Bonds**

Tax law, economics, and common sense happily coincide in the straightforward case of a bond sold at par: Annual coupon payments are treated as interest, and no principal is recovered until maturity. Implicit yield and current coupon payments are identical if yield is computed based on compounding at a frequency equaling the frequency of interest payments on the bond. The amount of outstanding indebtedness thus neither increases nor decreases, and current payments are treated entirely as income, rather than return of principal.

If a par bond were analyzed, not as one debt, but rather as a series of original issue discount obligations, the amount includable in income each year (on a constant interest method of calculating the accretion of discount and assuming compounding consistent with the frequency of actual interest payments) would precisely equal the bond's annual coupon payment.\textsuperscript{19} Consider a five-year $100 bond sold at par, paying interest once annually at the rate of 12 percent, that is, $12 per annum. If the bond were viewed as five payment obligations, the schedule of the obligations, and their present values when issued (at a yield to maturity of 12 percent compounded annually), would be as follows:

\textsuperscript{18} The three paradigmatic money loan cases may also be described as the case where current cash flow equals the obligation's yield (a par bond), where current cash flow is less than yield (a discount obligation), and where current cash flow exceeds yield (an installment loan).

\textsuperscript{19} For a holder or issuer who uses the cash method of accounting, an original issue discount analysis of a par bond differs somewhat in timing from the conventional analysis if the coupon payment dates do not coincide with the taxpayer's fiscal year. The differences result from the differences between the rules for the deduction of interest paid and the inclusion of interest received by cash method taxpayers, on the one hand, and the mandatory accrual rule of section 1232A, on the other.
Year | Payment | Present Value
---|---------|----------------
1  | $12     | $10.71
2  | $12     | $9.57
3  | $12     | $8.54
4  | $12     | $7.63
5  | $112    | $63.55

$100.00

At the end of Year 1, the present values would have increased in value in the aggregate by $12, and the present value of the remaining payments would continue to equal $100:

<table>
<thead>
<tr>
<th>Year</th>
<th>Present Value—Beginning of Year 1</th>
<th>Present Value—End of Year 1</th>
<th>Increase in Value</th>
<th>Present Value of Future Payments—End of Year 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10.71</td>
<td>$12.00</td>
<td>$1.29</td>
<td>$10.71</td>
</tr>
<tr>
<td>2</td>
<td>9.57</td>
<td>10.71</td>
<td>1.14</td>
<td>9.57</td>
</tr>
<tr>
<td>3</td>
<td>8.54</td>
<td>9.57</td>
<td>1.03</td>
<td>8.54</td>
</tr>
<tr>
<td>4</td>
<td>7.63</td>
<td>8.54</td>
<td>0.91</td>
<td>8.54</td>
</tr>
<tr>
<td>5</td>
<td>63.55</td>
<td>71.18</td>
<td>7.63</td>
<td>71.18</td>
</tr>
</tbody>
</table>

$12.00 | $100.00

Thus, following the adoption by TEFRA of a yield to maturity methodology for original issue discount under section 1232A, the amount of interest income includable in respect of a par bond is clear, whether that result is reached by simply looking to the amounts designated by the instrument as interest or by analyzing the bond as a stream of original issue discount cash flows under the serial maturity methodology of the section 1232 regulations.²⁰

This mathematical truism forecloses at least one transaction designed to take advantage of straight line accounting for original issue discount under pre-TEFRA law. Before TEFRA, there were distinct tax advantages to issuers in offering bonds which were unremarkable in every respect, except that they paid no interest for the first year or two.²¹ The effect of such a provision under the regulations was that all payments on the bond (whether denominated interest or principal) were treated

²⁰Reg. § 1.1232–3(b)(2)(iv). These regulations have not yet been revised to reflect the adoption of a yield to maturity methodology by TEFRA.

²¹An example of such a debt obligation is the "Principal Payment Note" described in Caterpillar Tractor Co., Preliminary Prospectus Supplement (July 14, 1982).
as part of the “stated redemption price at maturity.”\textsuperscript{22} In effect, the
bond was considered a serial maturity instrument with each payment
considered a mini-bond issued at a discount. After TEFRA, such an
instrument presumably would still come within the serial maturity rules,
but this characterization would not improperly accelerate any deduc-
tions, because annual amortizations of original issue discount would be
calculated on a yield to maturity basis rather than a straight line basis.

\textit{Market Discount and Coupon Stripping}

From a nontax perspective, there is no difference to a prospective
holder between market and original issue discount. Before taking tax
effects into account, an investor should be indifferent between a 20-year,
eight percent corporate bond originally issued at par ten years ago,
priced to yield 12 percent, and a new ten-year issue of the same obligor
with an eight percent coupon sold at an original issue discount to yield
12 percent.\textsuperscript{23} Yet the two obligations are not equivalent for tax
purposes: A purchaser of the market discount bond will recognize discount
as capital gain on sale or exchange or retirement at maturity, while a
holder of the original issue discount obligation must include the same
discount in ordinary income on a yield to maturity basis over the life of
the instrument.\textsuperscript{24}

This anomaly is so ingrained in the tax law that it would hardly be
worth noting again, were it not for the fact that TEFRA has (perhaps
unintentionally) introduced provisions that in some circumstances trans-
mute market discount into original issue discount. New section 1232B
extends the annual income inclusion rules for original issue discount
obligations to coupon stripping, that is the removal from a coupon
bond of one or more interest coupons that are not yet payable and the
disposition of either the coupons or the stripped bond. Under section
1232B, a purchaser of a stripped bond or coupon is treated as if he pur-
chased an original issue discount obligation issued on the purchase date
for an amount equal to the purchase price.\textsuperscript{25} If the purchase price is
less than the face amount of the coupon or bond, the difference is original
issue discount unless it is within the de minimis rule or some other ex-
ception to the definition of original issue discount. Because the purchase
price is determined by the interest rates prevailing when the purchase
occurs, the original issue discount to the purchaser may reflect market

\textsuperscript{22} Reg. §§ 1.1232–3(b)(1)(iii); 1.1232–3(b)(2)(iv)(c).
\textsuperscript{23} The text assumes that the two obligations are identical in call protection and
other features.
\textsuperscript{24} I.R.C. §§ 1232(a)(1), 1232A(a)(1).
\textsuperscript{25} I.R.C. § 1232B(a).
discount that resulted from a rise in interest rates or some other factor occurring since the coupon or bond was actually issued. Likewise, a seller who retains a stripped bond or coupon is deemed to have acquired the retained instrument as an obligation newly issued on the sale date for an issue price equal to the portion of his basis that is allocable to it. His original issue discount, the difference between the face amount of the retained coupon or bond and the allocated basis, also reflects market discount if he purchased the unstripped bond at a market discount. The purchaser and seller must include this imputed discount in income on a yield to maturity basis.

Moreover, section 1232B requires that the original issue discount associated with a stripped coupon or stripped bond be recalculated each time it is sold. As a result, by reflecting market price fluctuations in the issue price of a stripped bond or coupon, the new rules also have the effect of converting market discount arising after the stripping into original issue discount with respect to each purchaser of that stripped bond or coupon.26

For example, consider a $1,000 face amount eight percent coupon security issued at par, paying semi-annual coupon interest each December 1st and June 1st, and maturing on December 1, 1992. If the security were trading at a 12 percent yield to maturity, its market price on December 2, 1982 would have been roughly $770. Assume on that date the owner of the entire security sold or gave away the last coupon on the bond (that is, the right to $40 on December 1, 1992), having a market value of $12.87, to one person, and sold the stripped bond with the remaining coupons to another person for $757.13 (that is, $770 less the $12.87 value of the missing coupon). The purchaser of the stripped bond is treated as having acquired a serial maturity obligation with $242.87 in original issue discount, $230 of which is economically attributable to market discount on the old security and only $12.87 of which is attributable to the coupon stripping itself.27

26 The discussion in the text relates only to taxable securities. Special rules apply in the case of tax-exempt obligations. See letter from James M. Peaslee to John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, reprinted in XVI TAX NOTES 358 (Nov. 1, 1982).

27 The rules of § 1232B would also apply if the stripper retained the stripped bond himself. Assume the coupon stripper purchased the entire security for $770 and immediately stripped and sold the last coupon. His basis of $770 would be apportioned between the portion of the security disposed of and the portion retained according to their respective fair market values. The basis thus allocated to the portion retained would be ($770 × ($770 — $12.87)/$770), or $757.13. The difference between such allocated basis and the $1000 payable at maturity, or $242.87, would be original issue discount on the retained security. Also, § 1232B would create a small amount of discount ($16.71) even if the coupon stripper had purchased the entire security for $1,000. The discount
Thus, section 1232B makes the traditional distinction between market and original issue discount still more incongruous, by treating discount that is primarily attributable to market fluctuations as original issue discount. The theoretically correct resolution of the anomaly is to treat identically all components of bond yield, whether denominated coupon interest, market discount, or original issue discount. As a matter of legislative draftsmanship, such a result could easily be implemented by expanding the scope of section 1232B to cover all secondary bond trading (subject, perhaps, to liberalized de minimis rules). At a practical level, however, the substantial impact of such a change on current trading levels of deep (market) discount securities, and the difficult record keeping and enforcement problems that the change would raise, may impel Congress to continue to tolerate theoretical asymmetry as the price of political peace.

**Bond Premium**

The taxation of bond premium (whether original issue or market) is a byway infrequently travelled in recent years, when ever increasing interest rates made last week’s par offering this week’s discount security. The more recent reversal of this trend, however, suggests that the tax rules for bond premium will receive increasing attention in the future.

If a taxpayer purchases a corporate bond at a premium (whether original issue or market premium), the taxpayer may amortize the premium by any reasonable method regularly employed by the taxpayer, or on a monthly straight line method. An issuer must include original issue premium in income ratably over the life of the bond. The amount of premium so amortizable is generally the amount determined by reference to the amount payable on maturity, spread over the period until maturity. If, however, the bond is callable, and a holder's annual deductions for the period before the call date would be smaller if calculated by reference to the call price and the period remaining until the call date, the taxpayer can amortize only that smaller amount. I.R.C. § 171(b)(1)(B)(2). If serial maturities are involved, a bond year method similar to that used in the regulations under § 1232 is employed. See Rev. Rul. 70-353, 1970-2 C.B. 39.

Reg. § 1.61-12(c). The regulation is unclear as to the time over which the issue of a callable bond must include any premiums in income.
of both holders and issuers, premiums attributable to conversion features are excluded in the calculations.\footnote{Reg. § 1.171–2.}

The tax treatment of premium is significantly different from the tax treatment of discount. First, market premium on a debt instrument generates deductions against ordinary income to the holder, while market discount is accounted for as capital gain at maturity. Second (and more relevant to this article), premium, whether market or original issue, continues to be amortized on a straight line basis, in contrast to the economic accrual method now mandated for original issue discount.

By permitting a holder to amortize bond premium on a straight line basis, the tax law preserves in the bond premium area precisely the same type of economic distortions that the pre-TEFRA rules provided for original issue discount. Just as an issuer of original issue discount securities formerly received accelerated tax deductions for the discount, so the purchaser of a premium bond can amortize premium on a basis more accelerated than economic accrual. Similarly, an issuer of an original issue premium security is disadvantaged in the same manner as was the holder of an original issue discount security before TEFRA. As a practical matter, this disadvantage makes original issue premium uncommon since an issuer will simply not issue such an instrument unless the accelerated inclusion of premium has no practical effect, because, for example, it has a net operating loss carryover. Market premium, however, provides an advantage to a purchaser of a premium bond which is not offset by a disadvantage to any other person.

Consider, for example, a noncallable $100 bond due in five years paying interest of 16 percent.\footnote{The figures that follow assume that interest is paid once each year, beginning one year from the date of issuance or purchase.} If that bond were priced to yield 12 percent, its current value would be $114.42.\footnote{One way of conceptualizing this figure is to compare the difference in cash flows between the bond in the example and a $100 par bond of the same maturity. By hypothesis, the par bond would have a 12\% annual coupon rate; accordingly, the difference in cash flows is $4 per year for five years ($16 — $12). The present value of an annuity of $4 per year for five years at a 12\% discount rate is $14.42.} The $14.42 premium paid can be amortized for tax purposes on a straight line basis, or $2.88 per year. Economically, however, the premium accrued in the first year equals the difference between (1) the price paid for the bond at the outset and (2) the value of the bond (at the same 12 percent yield) at the beginning of the second year. A 16 percent coupon bond with four rather than five years to maturity has a present value of $112.15, so that the economic amortization for the first year is $114.42 minus
$112.15, or $2.27. Economic and tax amortizations over the life of the bond are contrasted below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Economic Amortization</th>
<th>Tax Amortization</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$2.27</td>
<td>$2.882</td>
</tr>
<tr>
<td>2</td>
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The economic amortization schedule is, in effect, a compound interest table: That is, $2.27 invested for one year at 12 percent grows to $2.54, in two years to $2.85, et cetera. The methodology underlying the economic amortization schedule is identical to the yield to maturity method of amortizing original issue discount introduced by TEFRA. Indeed, following the section 1232A model, the premium to be amortized could be viewed as the excess of (1) the interest paid on the bond during such year over (2) the yield to maturity multiplied by the taxpayer's basis as of the beginning of the year.

Thus, while TEFRA introduced an economic measurement of interest in the original issue discount area, it ignored the reverse side of the same coin, the annual amortization deduction permitted holders of amortizable intangible assets with known cash flows. Bond premium is but one example of the fact that, if the same economic analysis that TEFRA applied to original issue discount obligations is extended to amortizable intangible assets that decrease in value with the passage of time, straight line amortization is, in reality, an accelerated method of basis recovery.

34 The more direct way to reach this result is to observe that a 16% coupon security has a cash flow of $4 per year higher than a 12% bond. Thus, the difference in value between the 5-year 16% bond and a 4-year 16% bond (at a 12% discount rate) is the right to one additional $4 payment in five years. The present value (at 12%) of $4 payable in 5 years is $2.27.

35 As described in the preceding footnote, this table is, in effect, a table of the present values (at a 12% discount rate) of the right to receive $4 in 5, 4, 3, 2, and 1 years in the future.

36 The above critique of the straight line amortization of bond premium is equally applicable to the acquisition of any intangible asset with a stream of known cash payments. For example, if an investor were offered the opportunity to acquire a triple net lease paying $100 per year for 10 years, and the leasehold interest were priced to yield the investor a 12% return on his investment, the investor's cost for the leasehold would be $565. Under current law, the investor would be able to amortize the purchase price ratably over the 10-year life of the leasehold. Reg. § 1.167(a)–3. Cf. Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953).
Distinguishing Between Interest and Principal on an Installment Loan

The federal income tax rules on the allocation between principal and interest of payments on a self-liquidating installment loan have been a quagmire of outmoded theories applied without regard to any economic concept of interest.\(^{37}\) The cases and rulings have focused on the "intentions" of the parties, or have applied mechanical formulae (such as straight line amortization of interest or the "Rule of 78s" method of allocating principal and interest). As previously noted, however, interest should accrue on an installment loan at the rate of the yield to maturity multiplied by the debt balance at the start of the year. Any payments in excess of the interest thus accruing properly reduce the principal balance. These principles of economic accrual properly reflect congressional intention as expressed in the enactment of section 1232A. It is only recently, however, in Revenue Ruling 83–84,\(^{38}\) that the Service has recognized the significance of section 1232A in this context. The confused body of law which preceeded the Service's recent pronouncement is discussed below, followed by a discussion of Revenue Ruling 83–84.

Revenue Ruling 63–57 holds that lender and borrower can agree to allocate each installment paid on an installment loan between principal and interest in any manner they please, including allocating initial installments entirely to principal.\(^{39}\) This result (largely based on cases dealing with compromise settlements of principal and interest)\(^{40}\) has been defended on the grounds that lender and borrower have tax adverse

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The tax law is less settled as to the case of an investor who acquires, not just a leasehold, but ownership of the underlying real estate subject to a premium lease. Fieland v. Commissioner, 73 T.C. 743 (1980). On an economic accrual basis, however, the investor should be permitted to deduct each year only the diminution in value of his intangible asset during that year, computed on the same yield assumption as underlay his investment: That is, the investor's amortization deduction in the first year should equal the excess in value of a 10-year $100 annuity over a 9-year $100 annuity, at a 12% yield. That difference is $32.18, not the $56.50 permitted by current law.

\(^{37}\) For an excellent critique of this area, see Note, Interest and Principal: A Failure of Definition in the Internal Revenue Code, 72 YALE L.J. 200 (1962).

\(^{38}\) 1983–23 I.R.B. 12 (June 6).

\(^{39}\) 1963–1 C.B. 103. Query, however, whether a deduction for interest computed by allocating installments entirely to interest first would be challenged by the Service, on the ground that it represented prepaid interest. \textit{See} I.R.C. § 461(g) (generally disallowing prepaid interest deductions by cash method borrowers). Rulings preceding § 461(g) denied deductions for prepaid interest in the case of cash-basis taxpayers. \textit{See}, e.g., Rev. Rul. 68–643, 1968–2 C.B. 76. Interestingly, Revenue Ruling 68–643 also states that, in the case of accrual basis taxpayers, interest accrues "ratably" over the period of the loan.

\(^{40}\) \textit{See}, e.g., Huntington-Redondo Co. v. Commissioner, 36 B.T.A. 116 (1937); \textit{acq.}; Sefton v. Commissioner, 292 F.2d 399 (9th Cir. 1961).
interests in negotiating the earmarking of installments between principal and interest, and that "there is usually no economic model to which the payments should conform." \(^{41}\)

There exist so many instances of lack of tax adverse positions in money loan transactions that to defend taxpayers' freedom to earmark installment payments as they will on this basis is to encourage a wide range of whipsaw problems for the Treasury.\(^{42}\) The second argument, that there exists no compelling economic model to which installment loans should conform, also should be rejected in light of section 1232A, which adopts economic accrual as the norm.

Where the loan agreement does not specifically allocate payments between interest and principal, the courts and the Service (until Revenue Ruling 83-84) have wandered along unguided by the true compass of economic accrual. Thus, the leading case to consider the allocation of timely installment payments on a self-liquidating installment loan in the total absence of evidence as to the parties' intent produced a result not easily defended on economic grounds. In *James Brothers Coal Co. v. Commissioner*,\(^ {43}\) the taxpayer, in 1960, borrowed $164,684 from a bank for three years, "with interest computed by the bank at 5½ percent per annum for the entire 3-year period in the total amount of [$27,173]." \(^{44}\) The taxpayer agreed to repay this aggregate indebtedness of $191,857 (principal and interest), which was evidence by a single promissory note in that amount, in 36 equal monthly installments of $5,329.\(^ {46}\) The taxpayer apparently made seven monthly payments during the remainder of 1960, totalling $37,305. Since the loan was self-liquidating, some portion of this $37,305 was principal repayment and some interest. However, the promissory note itself did not allocate between principal and interest, and no other evidence of any kind was introduced into evidence to support any particular allocation method.

The taxpayer in *James Brothers* claimed a deduction on its 1960 tax return with respect to interest that had accrued during the first seven months of the loan's term by apportioning the aggregate interest pay-


\(^{42}\) Consider, for example, the following pairs of lenders and borrowers: Tax-exempt pension fund lender and taxpaying borrower; taxpaying lender and nominally taxpaying borrower with substantial net operating loss carryovers; small loan company and customers who in the main do not claim itemized deductions.

\(^{43}\) Id. at 917 (1964).

\(^{44}\) Id. at 918. All amounts are rounded for convenience.

\(^{45}\) Thus, while the bank stated interest on its loan as 5½ percent simple interest ($27,173 = $164,684 \times 5½\% \times 3$), the effective rate of interest on the loan was considerably higher (about 10.2% per annum), because the bank performed its interest calculation on the total amount borrowed for three years, despite the fact that the taxpayer paid down a portion of its principal indebtedness each month.
able among the 36 monthly payments under the sum of the months digits method, more frequently called the Rule of 78s. Under this method (which is identical in computation to sum of the year digits depreciation), the taxpayer first summed up the integers from 1 through 36, which number is 666.46 The taxpayer argued that its first monthly payment represented a payment of 36/666 of its $27,173 aggregate interest obligation, the second payment 35/666, down to the last month of the loan, when 1/666 of the aggregate interest would be treated as paid.47

The Rule of 78s is (or at least was) a popular means for commercial lenders to calculate interest on installment loans. In an era before electronic calculators, its application was simpler than economic accrual, and the results were roughly comparable (at least, where loans of relatively short maturity and low interest rates are concerned). Early installment payments consist mostly of interest; then, as principal is repaid, the portion of each payment allocable to interest declines, and the portion allocable to principal increases.48 Under the Rule of 78s, the taxpayer in James Brothers should have claimed an interest deduction of $9,425.49 Had it calculated its interest deduction under the constant interest method, it would have claimed a deduction of roughly $9,090.

The Tax Court, agreeing with the Service, rejected the taxpayer's

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46 The term "Rule of 78s" derives from the fact that the sum of the integers from 1 through 12 is 78. The formula for computing the sum of the integers for any period is: \( (n \times (n + 1))/2 \).

47 The Tax Court had previously held (in an acquiesced case), and the Service has since confirmed, that "The general rule relating to the treatment of payments on an indebtedness requires that partial payments in satisfaction of indebtedness be applied first toward the reduction of interest, then toward principal." Rev. Rul. 70-467, 1970-2 C.B. 38, citing Bowen v. Commissioner, 2 T.C. 1 (1943), acq. A literal application of this general rule would suggest that the taxpayer in James Brothers repaid its entire $27,173 interest obligation with respect to its 3-year loan in the first seven months of the loan, but the taxpayer apparently lacked either the vision or the temerity to advance this argument.

While it is probable that the above general rule should apply only to accrued interest, and not to interest attributable to future periods, nonetheless, given the general flexibility permitted taxpayers in this area (see supra notes 39 & 40), it is surprising that the taxpayer in James Brothers did not argue that it had paid 3 years' interest in the first 7 months. Such an argument would have been no more implausible than the Tax Court's holding that 3 years' interest should be treated as paid in equal installments, despite the fact that the taxpayer's principal obligation declined each month.

48 One advantage of the Rule of 78s is that a commercial lender can compute its periodic interest income by aggregating all loans made in one period with the same maturity, regardless of the interest rate on those loans. D. THORDIKE, THORDIKE'S COMPOUND INTEREST AND ANNUITY TABLES 80 (1982).

49 Unfortunately, the taxpayer's record keeping made it impossible for the Tax Court to determine exactly how much the taxpayer had claimed as an interest deduction with respect to the loan in question.
reliance on the Rule of 78s. Instead of requiring that interest be calculated on a constant interest basis, however, the court held that the $27,178 in aggregate interest charges for the three years of the loan was deductible on a straight line basis, thereby entitling the taxpayer to only 7/36 of $27,173, or $5,284, as an interest deduction in the first year of the loan. In reaching its conclusion, the Tax Court stressed that (1) the taxpayer's obligation to pay both principal and interest was incorporated in a single promissory note repayable in equal installments which should not be fragmented into 36 separate monthly obligations in applying the Rule of 78s, 50 (2) no proof was offered as to the taxpayer's right to avoid any of the aggregate interest charge by prepaying the note, and (3) the result reached was consistent with at least one early ruling. 51

In subsequent rulings, the Service applied the ratable accrual rule adopted in James Brothers where another method of interest apportionment was not specified by the parties. 52 Yet it is difficult to believe that a court reconsidering the issue would reach the same result. By allocating three years' aggregate interest charges equally among 36 monthly payments, the Tax Court, in James Brothers, in effect determined that the taxpayer-borrower should be deemed to pay a constant amount of compensation for the use of a steadily decreasing principal sum. (In this sense, the result achieved in James Brothers was the inverse of the distortions created by pre-1982 straight line amortization of original issue discount, where a constant amount of periodic compensation was deemed paid for the use of a steadily increasing principal sum.) This result can be seen as inferring that the parties intended that the loan at issue bear interest at a substantially lower than normal rate at first, which rate would then increase with each payment, until it reached much higher

50 Significantly, the Regulations under § 1232 (adopted after the James Brothers case) could be interpreted as fragmenting an installment loan into a number of mini-bonds subject to the original issue discount rules. See Reg. §§ 1.1231–3(b)(1)(iii)(a), 1.1232–3(b)(2)(iv).

51 I.T. 3489, 1941-2 C.B. 71, superseded by Rev. Rul. 72-100, 1972-1 C.B. 122, modified and superseded by Rev. Rul. 83-84, 1983-23 I.R.B. 12 (June 6). No doubt the court was also influenced by the fact that the aggregate interest payable was calculated on a simple interest basis, though, as described above, that simple interest number bore no relationship to the effective interest rate on the loan.

than market rates. Such an analysis is inconsistent with normal commercial and financial practice. At best, then, *James Brothers* can be explained as the failure of the taxpayer to prove any relevant facts, and the Tax Court and the Service responding with a rule of convenience designed to do rough justice.

If interest is compensation for the use of money for a specified period, *James Brothers* represents an implicit determination by the Tax Court that the parties intended a compensation arrangement that can most kindly be described as outside the ordinary course of simple installment bank loans. Not surprisingly, then, almost immediately after *James Brothers*, the Tax Court adopted a different approach to the apportionment of installment loan payments between interest and principal, which approach paid careful attention (perhaps too much so, for the reasons described below) to the detailed terms of each loan in question. These cases were soon endorsed by a series of revenue rulings. In effect, these cases and rulings held that, at least from the perspective of an accrual

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53 If the taxpayer had issued 36 original issue discount obligations and amortized the discount on a constant interest basis, it would have accrued an original issue discount deduction equal to the interest deductible on an economic basis. As pointed out earlier, this amount is close, for interest rates and loan periods commensurate with those in *James Brothers*, to the amount yielded by the Rule of 78s.

54 Gunderson Bros. Eng'g Corp. v. Commissioner, 42 T.C. 419 (1964), *acq.*. *acq. explained*, Rev. Rul. 67–316, 1967–2 C.B. 171; Luhring Motor Co. v. Commissioner, 42 T.C. 732 (1964). Both cases involved accrual method automobile dealers that offered financing terms to retail automobile purchasers. In each case, a purchaser (as in *James Brothers*) signed a single note for an aggregate amount equal to the principal amount (the purchase price of the automobile) plus interest for the term of the financing, and agreed to repay that amount in equal monthly installments. In each case, a purchaser could prepay his loan, and a portion of the aggregate finance charge would be abated. In *Gunderson*, the taxpayer calculated its income (and the amount to be abated in the case of prepayments) on the Rule of 78s method; in *Luhring Motors*, the taxpayer consistently used a straight line approach. In both cases, the Service argued that the total finance charges were includable in the accrual method sellers' income in the year of sale, apparently on the theory that all events had transpired to fix the taxpayers' right to that income. The Tax Court rejected that analysis, on the basis that "the event which makes the purchaser liable for the finance charge is not the signing of the contract but rather it is the passage of time without his making any early payment." 42 T.C. at 428. Since both cases were concerned primarily with the Service's contention that the aggregate finance charge was immediately includable in income, neither discussed in detail the propriety of the Rule of 78s or straight line method of apportioning interest, except to note that the taxpayers applied the same methods for income tax purposes and for purposes of calculating prepayment abatement.

method lender, installments received on an installment loan are allocable to interest at the same rate that the lender’s obligation to abate any of the aggregate finance charges because of a prepayment is relieved by the passage of time. Accordingly, if the loan documentation or state law provided that a lender’s right to interest accrued under the Rule of 78s, the Service permitted that method to be used to apportion installments between interest and principal for federal income tax purposes.\footnote{Rev. Rul. 72–100, 1972–1 C.B. 122, modified and superseded by Rev. Rul. 83–84, 1983–23 I.R.B. 12 (June 6). Revenue Ruling 72 100 confusingly refers to installment loans of the type analyzed therein as “discounted” installment loans, because the note signed by a borrower, like the notes in James Brothers, Gunderson Bros., and Luhring Motors, is for an amount equal to the principal of the loan plus the total finance charges over the term of the loan, while the amount disbursed to the borrower is, of course, only the principal amount. The confusion was compounded in Revenue Ruling 72–562, 1972–2 C.B. 231, modified and superseded by Rev. Rul. 83–84, 1983–23 I.R.B. 12 (June 6), which contains the following colloquy intended to “clarify” Revenue Ruling 72–100: “Question 1. Does the term installment loans made at discount include loans made with add-on interest (i.e., a loan in which the interest is added to the principal amount of the loan made to the borrower)? Answer. Yes.”}

Relying on the amount required to prepay an installment loan to determine the amount of interest income received by a lender (and, presumably, paid by a debtor) improperly mingles the two different concepts of the economic accrual of interest and prepayment penalties. It is common in commercial and finance loans to provide for prepayment penalties.\footnote{A typical long-term bond, for example, might permit no prepayment at all for}
sumer loans) also are fond of prepayment penalties. One means to achieve that result without explicitly specifying a prepayment penalty is to allocate installment payments disproportionately slowly to principal. This is precisely the distortion achieved by the Rule of 78s as compared with economic accrual. (Of course, the result is even more skewed when the agreement purports to allocate all payments first to the aggregate interest due over the original term of indebtedness.) The Rule does not determine the aggregate interest received by a lender and paid by a borrower on an installment loan held to maturity; rather, it simply allocates the aggregate interest paid over the life of the loan to each period in a manner different (the degree of difference being a function of interest rates and period to maturity) from the constant interest method would suggest. The effect of that allocation, when compared to the allocations of installment payments under the constant interest method, is always to defer principal repayments. This timing difference is not very great on short-term loans at the interest rates prevailing when the Service first articulated its views; but when applied to longer-term installment loans at double digit rates, it can result in substantial distortion. Indeed, in some cases the Rule may result in the amount required to prepay the self-liquidating loan in the first few periods of its term increasing from period to period. Thus, in practical application, it appears that the Rule of 78s should be viewed as a hidden prepayment penalty, not an accurate measure of the interest cost per period.

Supporting accrual of interest deductions by reference to the amount payable on prepayment is particularly anomalous since the departure from economic accrual concepts engendered by such a rule is greatest in those cases where prepayment is least likely as a practical matter. Thus, if all early payments are attributed to interest under the loan documentation (a result not likely to be upheld in bankruptcy or under most

the first five years, and then permit prepayment only by payment of a penalty beginning at one year's interest, and scaling down to zero immediately before maturity.


60 "If the loan runs to maturity, how the lender allocates the [finance] charge does not concern the borrower. If, however, the borrower prepa...

61 Cf. THORDIKE, id. at 81 ("In general, at high rates and for long terms the rule increases earnings in the early years by a measurable amount.")

consumer credit laws), prepayment would be highly unlikely, as a practical matter, since the borrower’s cost of borrowing would increase markedly as the result of prepayment.\textsuperscript{63} In such a case, the prepayment clause truly exacts a penalty not likely in fact to be paid. To permit all early payments to be treated as interest for tax purposes because of such a prepayment would be to distort the expected economics of the borrowing transaction.

Accordingly, neither the intention of the parties nor the measurement of prepayment obligations provides a logical or consistent method for accruing interest on installment loans. Consistent with the congressional endorsement of a mandatory constant interest method of accrual in original issue discount situations, the same mandatory rules should be applied to determine accruals of interest on installment loans. The mandatory application of a constant interest method of allocating installment payments between interest and principal is no more unfair than the mandatory application of that method to original issue discount obligations. Such a result substitutes a unified theory of the measurement of interest for the present freedom to manipulate tax results. Moreover, it comports with many state laws dealing with the allocation of payments between interest and principal when neither debtor nor creditor earmarks them.\textsuperscript{64}

Responding, in part, to the substantial distortions created by the application of the Rule of 78s to long-term loans made to finance real estate investments, the Service reconsidered its prior authorization of the Rule of 78s in Revenue Ruling 83-84.\textsuperscript{65} The ruling considers a level payment self amortizing, 12 percent, 30-year loan of $100,000, under the terms of which interest was earned in accordance with the Rule of 78s. The borrower’s annual payments were $12,414. On a constant interest basis, $12,000 (that is, 12 percent of the $100,000 principal borrowed) of the first year’s payment was treated as interest. Under the Rule of 78s, however, $17,575 (over $5,000 more than the total annual payment) was treated as interest in the first year. Relying on the requirement of section 446 that no method of accounting is acceptable if, in the opinion of the Commissioner, it does not clearly

\textsuperscript{63} This result follows from the fact that, if all interest is prepaid, a borrower can then hold on to the borrowed funds until maturity without any further economic cost. By prepaying, the borrower gives up this economic benefit for the period from the time of prepayment to the loan’s original maturity.

\textsuperscript{64} See e.g., Buckley v. Commissioner, 37 T.C. 664 (1962), acq.; Asimow, supra note 41, at 758.

\textsuperscript{65} 1983–23 I.R.B. 12 (June 6).
reflect income, the Service concluded that, as a general matter, only the constant interest method of apportioning interest to time periods was a permissible accounting method because any other method "fails to reflect the true cost of borrowing." As a matter of administrative convenience, however, the Service announced in a companion revenue procedure that the Rule of 78s would still be permitted for accounting for interest for short-term consumer loans.

The result of Revenue Ruling 83-84 is certainly appropriate, for the reasons articulated above, but its scope and authority are certain to be matters of substantial controversy. For example, the ruling concludes by holding only that interest may not be deducted by reference to the Rule of 78s; it does not address the tax treatment of a lender who has made such a loan. Similarly, the ruling does not discuss the application of its holding to a purchase money note outside the scope of the unstated interest rules of section 483. Logically, there is no reason why the ruling should not cover such a case, but tax shelter promoters who have relied on purchase money obligations with Rule of 78s provisions to generate accelerated interest deductions for investors can be expected to vigorously contest the issue. Finally, the scope of section 446 in this context is not certain; apparently, the Commissioner has never before relied on that provision to require accrual method taxpayers to apportion interest to taxable periods using any particular methodology.

While Revenue Ruling 83-84 might be viewed by the Service as a necessary response to an exploding area of tax abuse, a more satisfactory means of achieving the same result (as to transactions covered by section 1232) could be achieved by modifying section 1.1232-3 of the regulations to make it clear that installment loans should be treated as serial maturity obligations. Under that approach, each installment would

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66 Id.
67 Rev. Proc. 83-40, 1983-23 I.R.B. 22 (June 6). In order to qualify under Revenue Procedure 83-40, a loan must (1) be self-amortizing, (2) require level payments (without any balloon payments at maturity) at regular intervals at least annually, (3) have a term of no more than five years, and (4) provide that interest is earned, or upon prepayment is treated as earned, under the Rule of 78s.
68 In this context, it is important to observe that if a deferred payment obligation is within the scope of § 483 and has "total unstated interest," § 483 provides specific rules for the apportionment of each payment between interest and principal. I.R.C. § 483(a); Reg. § 1.483-2(a)(1)(ii). If, however, no total unstated interest exists, § 1.483-2(a)(1)(ii) of the regulations provides that "interest which is stated in the contract shall be treated in accordance with the rules of the Code otherwise applicable." The rules of § 483 are described in the next section of this article.
69 Note, Protecting the Public Fisc: Fighting Accrual Abuse with Section 446 Discretion, 83 Colum. L. Rev. 378 (1983).
be deemed to constitute a mini-bond issued at a discount, and the aggregate original issue discount accruing on all the mini-bonds in any period would be equal to an economic accrual of interest on the installment loan. This approach would be mandatory and would not be affected by consideration of prepayment penalties or the parties' intentions, which are difficult to gauge in any event. Transactions now within the scope of section 483 could be brought within this rule if the scope of section 1232 were expanded in the manner proposed in the final section of this article.

The operation of the original issue discount rules in this connection can be demonstrated through the example of an installment loan of $11,400 paying $300 per month for 48 months. That loan is equivalent to 48 $300 zero coupon obligations with serial maturities of from one to 48 months in the future. Under the constant interest method of amortizing original issue discount, the recharacterization of this hypothetical installment loan as 48 separate discount obligations produces an economic allocation of installments between principal and interest; that is, installments are first applied against accrued interest (measured by reference to the then-outstanding principal), and then to remaining principal, until the loan is entirely liquidated.

In those cases where the parties bargain for economic reasons to employ a method other than economic interest in determining the amount payable on prepayment or other events, applying section 1232 in the manner described above would not frustrate their intentions. If, for example, prepayment actually occurs and more principal remains unpaid than has accrued under an economic method, that difference should be treated as a prepayment penalty deductible to the obligor and taxed to the lender.

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70 The approach suggested in the text would also substitute a consistent method of amortizing points paid in connection with an installment loan for the current logically contradictory methods permitted different taxpayers. Compare Rev. Rul. 70–540, 1970–2 C.B. 101 (discount allocable to installment payments in proportion to amount of each payment; hence, if level payments, effect is straight-line amortization) with Rev. Rul. 64–278, 1964–2 C.B. 120 and Pacific First Fed. Sav. & Loan v. Commissioner, 79 T.C. 518, 516 (1982) (points included in income of a bank in proportion to amount of principal repaid during each period), and with Rev. Rul. 83–84, 1983–23 I.R.B. 12 (June 6) (Rule of 78s is not a proper method for amortizing "prepaid interest"; apparently, only economic accrual permitted.)

71 This is, of course, the method by which installments are allocated in the case of a standard level payment self amortizing mortgage. This result also comports with many state consumer lending laws, under which the amounts required to prepay an outstanding consumer installment loan must be calculated on the basis of a constant interest calculation, or the, at times, roughly equivalent Rule of 78s.

72 Reg. § 1.163–3(c).
Indebtedness Incurred in Exchange for Property

Deferred Payment Transactions Under Section 483

The preceding section of this article demonstrates the logical inconsistencies remaining after TEFRA in the measurement of interest and return of capital in money loan transactions. A second area in which taxpayers seek to exploit noneconomic concepts of interest relates to deferred payment transactions described by section 483 and not covered by section 1232 (herein referred to as section 483 transactions).

Section 483 provides that in the case of a deferred payment contract for the sale or exchange of property, portions of amounts denominated as principal are recharacterized as unstated interest and treated as ordinary income to the recipient and deductible by the payor if the contract does not provide adequate interest on the deferred payments. Interest stated as such in the contract is adequate to avoid the imputation of interest under the current section 483 regulations if it has a present value equal to at least nine percent simple interest (the test rate). Payments due within six months of the sale do not bear unstated interest under section 483, and there is no unstated interest if all payments are due within one year after the sale. If the test rate is not met, purported principal payments are recharacterized as interest to the extent that such imputed interest, together with any stated interest, provide a specified rate of return (currently ten percent, compounded semi-annually). Section 1.483-2(a)(1)(ii) of the regulations provides that normal tax accounting principles determine when stated interest is gross income to the seller and deductible by the buyer. By contrast, unstated interest is prorated among the payments subject to section 483 in accordance with their relative amounts, and is includable in income and deductible only when paid or required to be paid, depending on the holder’s and obligor’s respective accounting methods. If a deferred purchase obligation passes the test rate (and if there is no original issue discount under section 1232), none of an obligation’s principal amount is recharacterized as disguised interest.

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73 I.R.C. § 483(c)(1); Reg. § 1.483–1(d)(1)(ii)(C).
74 I.R.C. § 483(e)(1).
75 I.R.C. § 483(b); Reg. § 1.483–1(e).
76 Reg. § 1.483–2(a)(1)(ii).
77 Section 1.483–1(b)(3) of the regulations, in effect, provides that the original issue discount rules of § 1232 take priority over the deferred payment rules of § 483. Accordingly, the expansion of the scope of § 1232 has the effect of diminishing the role of § 483.
As noted in the next section of this article, the Technical Corrections Act of 1982 has extended the scope of section 1232, at the expense of section 483, in certain deferred payment transactions. Section 1232A, in its current form, provides more rational results than section 483, principally because (1) section 1232A incorporates economic accrual concepts, while section 483 provides for the timing of interest recognition in a confused, often irrational manner; (2) section 1232A mandates consistent treatment of borrower and lender, while section 483 leaves the parties to their respective accounting methods; and (3) section 1232A automatically reflects the yield to maturity established by the market, while section 483 uses rates provided by regulations which are infrequently amended and do not take into account the effect of an obligation's term on its yield.

Nevertheless, many transactions continue to be governed by the woefully deficient rules of section 483. As discussed below, section 483 transactions often exploit one or more of the following structural defects in section 483 and its regulations: (1) the test rate rule which, under current regulations, excuses a transaction from section 483 if simple interest of nine percent or more is provided by contract; (2) the income and deduction timing rules; (3) the peculiar section 483 method for allocating unstated interest among multiple deferred payments; (4) the rule requiring recharacterization of a transaction if one or more deferred payment obligations are transferred after the initial sale; (5) the exception for sales in which all payments are due within one year; and (6) the exception from interest income recognition where the asset sold was not held as a capital asset.

**Capitalized Interest Transactions: Converting Interest Into Purchase Price**

If section 483 does not apply to deferred payments under a contract, contractual designations of payments as interest or principal control. Based on this rule, and the other rules in section 483 previously discussed, it is possible for buyer and seller to rearrange the terms of a deferred purchase transaction to maximize both parties' after tax return, by, in effect, understating economic interest and capitalizing the difference as sales price. The utility of this stratagem is affected by (1) the character of the seller's gain and the nature of any gain or loss that might be recognized by the buyer on subsequent resale, (2) the rate of basis recovery to the buyer, and (3) the timing of recognition of interest income to the seller and interest deduction to the buyer.

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79 See supra note 77.
For example, an owner of real estate worth $100 could sell it to a dealer for a note providing only for the payment of $112 in precisely one year. (Assume 12 percent is the prevailing interest rate). Section 483 would not apply because no payment would be due more than one year after the sale. The seller could qualify for installment sale treatment on his gain, and all $112 would be treated as sales proceeds, eligible for taxation at preferential capital gains rates if the asset sold was held as a capital asset. Thus, the seller has converted interest income into capital gain. Correspondingly, the buyer has converted interest expense into basis. In certain circumstances, he can recover that artificial increment in basis faster than he could deduct the same amount if it were denominated interest. The purchaser would take a $112 basis in the property; if he sold it immediately after its acquisition for $100, he would claim a $12 ordinary loss, and have $100 plus his tax savings from the loss to invest for one year before he would have to pay the seller $112.

As another example, assume that the property to be sold had a value of $100 and qualified for five-year ACRS cost recovery. Instead of funding the $100 purchase price at prevailing rates (12 percent), the purchaser could acquire the property from the seller for a note maturing in five years in the principal amount of $121, with simple interest accruing at the rate of $11 per annum, payable at maturity. At the end of five years, the seller would receive $176 ($121 principal, plus $11 interest times five years). Section 483 would not apply because the stated interest of $11 per year, though not paid until maturity, satisfies the nine percent test rate rule. This $176, however, includes a 12 percent compounded return to the seller, which we have assumed to be the prevailing rate, with the added advantage to the seller of (1) deferral of tax on the sale of the property under the installment sales rules, (2) conversion of $21 in economic interest into capital gain (assuming the asset sold is a capital asset), and (3) if the seller uses the cash receipts and disbursements method of accounting, deferral of all income inclusion until maturity. The purchaser, meanwhile, can recover $21 of artificial basis (reflecting economic interest) over five years under ACRS, and, if he is an accrual method taxpayer, deduct the $55 of stated interest over the life of the note. If the taxpayer were to claim

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80 I.R.C. § 483(c)(1)(A).
81 See I.R.C. § 453(b)(1).
82 See I.R.C. § 168.
83 I.R.C. § 483(c)(1); Reg. § 1.483–1(d)(2).
84 The stated interest presumably would be includable in income by an accrual method lender over the term of the indebtedness. Reg. § 1.483–2(a)(1)(ii).
85 Whether that $55 can be deducted ratably, or whether, instead, a yield to ma-
an $11 interest deduction each year, his first year interest deduction plus his first year ACRS deduction on the $21 of excess basis ($3.15) would equal $14.15, and, in the second year, an $11 interest deduction plus a $4.62 ACRS deduction, or $15.62. By contrast, had the purchaser financed the acquisition of the property by selling a five-year, zero coupon note with a face of $176 for $100 in cash, under section 1232A the purchaser’s deduction with respect to the first twelve months of the financing would be $12, and the second twelve months $13.44. The figures become even more dramatic if the maturity of the loan is set beyond the five year ACRS recovery period.

Another variant of the capitalized interest technique is to provide stated interest, payable as it accrues, at a rate somewhat below nine percent. This variant relies upon the often ignored fact that the section 483 regulations do not require that interest be paid annually; rather, they require that the present values of the sum of stated interest and principal payments, using a nine percent simple interest discount, equal the principal amount of the loan.\textsuperscript{86} Since nine percent simple interest payable at maturity satisfies the test, a smaller amount payable periodically also satisfies the test. For example, the minimum rate a 15-year obligation paying interest semi-annually can carry and meet the test rate of section 483 is roughly 6.15 percent.\textsuperscript{87} As maturities grow longer, the minimum coupon interest declines; for a 30 year obligation paying interest semi-annually, the section 483 test rate is met with a 5\% per cent current annual interest rate.\textsuperscript{88} By following this approach, less ag-

\textsuperscript{86} See Reg. § 1.483–1(d) for the detailed rules for applying this concept.

\textsuperscript{87} That figure is determined as follows: The present value of a principal repayment for test rate purposes is determined using column (a) of Table VII of section 1.483–1(g) of the regulations. The present value of current interest payments, which are analogous to an annuity (i.e., a promise to pay a fixed amount per period for a specified time), is determined under column (a) of Table VIII or IX, depending on whether interest is paid semi-annually or annually. The present value of $100 (principal repayment) due in 15 years is $100 \times 0.42553, or $42.55 (See Table VII, entry for 180 months, column (a)). The remaining $57.45 must equal the present value of the coupon interest if unstated interest is to be avoided. Under Table VIII, column (a), the present value of a $1 annuity paid semi-annually for 15 years is $18.70286. Dividing $57.45 by $18.70286 yields $3.07; that is, the present value of a $3.07 annuity paid semi-annually for 15 years at 9\% simple interest is $57.45. Doubling that $3.07 (to reflect two interest payments per year) means that the total coupon interest required each year for a 15 year obligation is roughly 6.15%.

\textsuperscript{88} These numbers are a function of the § 483 test rate, maturity of the obligation, and frequency of interest payment; they are unaffected by fluctuations in prevailing interest rates.
Compound Interest

aggregate interest is stated than would be the case if interest were all paid at maturity. However, paying all interest at maturity maximizes the tax advantage of such transactions in present value terms.

Deferred Interest Transactions

The preceding part described devices by which taxpayers, by structuring their transactions to fall just beyond the reaches of section 483, transmute what economically is interest into increased purchase price and emerge in superior after-tax positions. Those transactions rely on the low effective rate of interest required to meet the nine percent simple interest test rate and, in some cases, on disparities between the accounting methods of cash method sellers and accrual method purchasers. In deferred interest transactions under section 483, the aggregate amount of interest paid by buyer to seller over the term of a deferred purchase obligation might equal an economic rate of interest, but the differences between cash method sellers and accrual method purchasers provide dramatic tax savings to the parties.

In a deferred interest transaction, a cash method seller sells property to an accrual method purchaser for a note providing for stated interest that is not payable until maturity. As pointed out earlier, the section 483 test rate is satisfied, by definition, if an obligation bears stated interest of nine percent simple interest, deferred until maturity. While the cash method seller will report no income until the deferred payment obligation’s maturity, the accrual method purchaser will claim interest deductions during the life of the note.

Deferred interest transactions have become very popular in syndicated real estate offerings. From the perspective of a cash method seller, a deferred interest transaction appears to present no particular tax difficulties. If a seller has the misfortune of being an accrual method taxpayer (and thus would be required to include the deferred interest in income prior to maturity), a cash method corporate intermediary is often inserted into the transaction to buy the property on more conventional terms from the seller and resell the property on a deferred interest basis to the syndicated limited partnership. Interposition of such a sandwich corporation to protect an accrual basis seller presents obvious problems for both the seller and the corporation.

From the point of view of a purchaser, particularly a newly formed syndicated limited partnership, at least two interesting questions are raised. First, the Service could, in effect, attempt to place the partnership on the cash method, on the grounds that the accrual method does not clearly reflect income in this circumstance. At least one recent article has strongly argued in favor of such an approach, relying in part on
decisions allowing the Commissioner broad discretion in applying the
clear reflection requirement of section 446(b).\footnote{Note, Protecting the Public Fisc: Fighting Accrual Abuse with Section 446
Discretion, 83 Colum. L. Rev. 378 (1983).} Second, and more
relevant to this article, is the issue of how the purchaser's interest ex-
 pense should be determined each year.

Consider, for example, an accrual method partnership that acquires
real estate for a $100 ten-year note, carrying 18 percent simple interest,
deferred until maturity. Such a note has an economic yield to maturity of
roughly 10.8 percent. How should the $180 in interest payable in
year ten be deducted by the partnership?\footnote{So long as the $180 is viewed as interest, the test rate of the § 483 regu-
lations is met; the issue here is not whether total unstated interest exists—there
clearly is none—but rather how stated interest should be apportioned over the
life of the note.}

One approach, based on rulings and cases prior to Revenue Ruling
83-84 in the installment loan area,\footnote{See supra notes 54–55.} would be to ask what the partner-
ship's interest obligation would be upon prepayment, and to use that
answer to determine how much of the purchaser's interest obligation
accrues each year. Those rulings and cases held that an accrual method
lender's annual income should be the portion of the total interest that
would have been abated on a prepayment at the beginning of the year
but not on a year end prepayment. In this case, which is the converse,
the annual interest deduction of the borrower-purchaser partnership
would be measured, using this approach, by the amount of interest it
has committed itself to pay for the use of the money for that year by
electing not to prepay. Thus, in the example set out above, if the note
were prepayable at 18 percent simple interest to the date of prepayment,
the partnership would deduct $18 per year.

While this analysis draws support from the case law on installment
loans, it suffers from two deficiencies. First, it gives more weight to
prepayment than is appropriate, since the likelihood of prepayment in
deferred interest transactions is extremely remote. If deferred interest
does not compound in the prepayment calculus, the effective cost to
the partnership of its debt increases as the result of prepayment. For
example, if the partnership paid off the note after five years, its effective
cost of funds would be 13.7 percent per annum, while, as pointed out
earlier, the note's yield to maturity is only 10.8 percent. Thus, the part-
nership has a substantial economic disincentive to prepaying and would
prepay only if prevailing interest rates markedly declined. Indeed, the
likeliest prepayment scenario is acceleration on default. In the event of
such an occurrence in bankruptcy, it is likely that, as a matter of bank-
ruptcy law, the accrual of interest would be measured on an economic rather than a straight line basis.\footnote{92 See supra notes 6–9 and accompanying text.}

The second objection to the straight line deduction of deferred interest is that such an approach runs counter to the policy underlying the recent enactment of section 1232A, where Congress explicitly recognized the inappropriateness of straight line amortization of original issue discount. A deferred interest obligation is economically indistinguishable from a zero coupon original issue discount obligation; both are simply a promise to make a single payment of principal and accrued interest at a specific date in the future. In a transaction subject to section 1232A, the issuer of a zero coupon note cannot retain the right to use straight line amortization by issuing an obligation providing for deferred interest payments with prepayment and default rights measured on a straight line basis. As a policy matter, it is difficult to see why the issuer of a deferred interest obligation should ever be so permitted (even if section 1232A is not technically applicable because a nontraded obligation is issued for nontraded property), particularly if the only argument in favor of such accrual is a prepayment provision which has little economic substance.

Indeed, there is an argument that any deduction for accruing interest in such transactions (whether on a straight line or economic accrual basis) is precluded by section 1232. For purposes of section 1232, interest payable at maturity is treated as the equivalent of principal.\footnote{93 Reg. § 1.1232–3(b)(1)(iii).} It could be argued that the effect of this rule, together with the rule that there is no original issue discount where nontraded debt is issued for nontraded property,\footnote{94 Reg. § 1.1232–3(b)(2)(iii)(a).} is to preclude the issuer from claiming a deduction for such discount under the guise of accruing interest. This argument is discussed in greater detail in the following part of this section of this article dealing with debt for debt exchanges.

If the partnership in the example were to claim interest deductions on a yield to maturity basis, the result would comport both with economic reality and Congress’ legislative intent, as reflected in TEFRA. Obviously, this approach is less advantageous to the partnership than straight line deductions. Since such modesty does not usually become a tax shelter promoter, we need only observe that, were the partnership to use a yield to maturity approach, the Service could hardly object.

Another approach, apparently employed by some taxpayers in deducting deferred interest, is to turn common sense on its head, and allocate the aggregate amount of interest over the life of the obligation...
by applying the Rule of 78s, thereby creating an accelerated method of deducting what is economically original issue discount. The Rule of 78s is a rule of convenience employed in installment loans to apportion payments between principal and interest, in which relatively more interest is allocable to earlier periods because the principal amount outstanding on which interest is due decreases with each payment.\textsuperscript{95} The Rule of 78s, applied in that context, at least approximates economic reality. In a deferred interest transaction, in contrast, the principal increases in each period by the amount of the interest accrued but not paid during the period, and economic accruals of interest thus increase also throughout the term of the debt. The Rule of 78s is wholly indefensible in this context. The Service has recently held that “[t]he Rule of 78s is in no circumstances a proper method for amortizing prepaid interest that is paid in a lump sum.”\textsuperscript{96} Since, for example, a loan of $100 on which the borrower prepays $10 in interest is economically identical to a loan of $90 on which the borrower promises to pay $10 interest at maturity, the Service can be expected to object to the use of the Rule of 78s in deferred interest transactions as well.

Some section 483 transactions have been structured to provide for stated interest payable annually, but deferrable at the option of the borrower (or in the event of defined objective conditions, such as the absence of cash flow) to a later date without any penalty—that is, the deferred interest is not compounded or payable at a higher rate. (These transactions often involve sale-leasebacks with accruing but deferred rent under the leaseback, raising yet additional questions as to timing of accruals.) These transactions are obviously designed to fit within the doctrine of accruing but deferred interest deductions as expressed in \textit{Natco Corp. v. United States}.\textsuperscript{97}

\textit{Natco} involved “cumulative convertible income debentures” issued by a corporation emerging from a reorganization under section 77B of the Bankruptcy Act. Under the terms of the debentures, interest accrued at the rate of five percent per annum. Interest was stated to be a fixed obligation of the issuer only at maturity or, if sooner, upon the payment of any dividends or interest on certain other debt by the issuer. Prior to such time or times, interest was to be paid only out of net earnings or available surplus. At least 50 percent of available net earnings was in any event to be applied to the payment of cumulative interest. The taxpayer deducted interest as it accrued semi-annually. When it subsequently paid the accrued but deferred interest, it also claimed a

\textsuperscript{95} See supra note 46 and accompanying text.
\textsuperscript{97} 240 F.2d 398 (3d Cir. 1956).
deduction on the theory that the earlier accruals were improper. The Court denied the taxpayer's later claim, concluding that the earlier accruals had been proper, since the fixed obligation to pay at maturity was sufficient to sustain accrual.

In *Natco*, the deferral arrangement was motivated by the cash flow needs of a reorganized business and the need to pay off superior indebtedness. The application of its holding to cases where the deferral has obvious tax motivation is not at all clear. Since it is always economically advantageous to pay a constant liability later rather than earlier, deferrable interest arrangements should be analyzed in the same manner as deferred interest transactions: Despite the cosmetic niceties, it should be assumed that deferrable interest will be paid no earlier than the first date beyond which deferral will have an economic cost. The deductibility of that deferred interest by an accrual method borrower in earlier years thus should be determined by the same analysis as for any other deferred interest obligation as discussed above.

**Two Payment Deferred Purchase Transactions**

The tax opportunity described in this part, unlike those previously described, involves deferred payments subject to section 483. It relies on the explicit statutory mandate of section 483 for the allocation of unstated interest to a series of payments made by an obligor.

Deferred payments under a contract for the sale or exchange of property include "total unstated interest" if neither the nine percent simple interest test rate nor any of the exceptions to the operation of section 483 is satisfied. Unstated interest is calculated using a compound rate of interest (currently ten percent, compounded semi-annually). It is deductible by a purchaser-obligor for the taxable year in which paid (in the case of a cash method obligor) or the taxable year in which payment is due (in the case of an accrual method obligor).98 Although total unstated interest is determined using a compound interest calculation that gives proper effect to the time value of money, it is allocated among payments to which section 483 applies in proportion to the relative amounts of those payments.99 Depending on the timing of the various payments, the allocation rule either accelerates or defers interest accrual as compared with the economic accrual of interest.

The problem is not a confusion between simple and compound interest; rather, it is the failure to employ any time value concept at all to the allocation of total unstated interest to a series of payments. Taxpayers have developed a sophisticated technique to take advantage of

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98 Reg. § 1.483(a)(1)(ii).
99 I.R.C. § 483(a); Reg. § 1.483–1(a).
this flaw. Although there are many variations, the technique is most easily seen by the following example: Seller owns all the stock of a closely held corporation, which he is willing to sell for $10 million. Buyer, instead of offering $10 million in cash, offers Seller $250,000 cash and two promissory notes (or a single note providing for two payments), each in the amount of $10 million, without any interest, one due six months and one day after the sale, and one due 30 years after the sale. If 12 percent is the market rate of interest for obligors having credit ratings comparable to Buyer's, the fair market value of the package is roughly $10 million ($250,000 cash, plus $9,421,000 value of first note, plus $334,000 value of second note). The package, however, produces dramatic tax advantages for Buyer.

Under section 483, the deferred purchase contract offered by Buyer would provide two payments to which section 483 would apply.100 These payments would include total unstated interest equal to the aggregate of the payments (exclusive of the $250,000 cash), or $20 million, less the present values of the two $10 million payments, as determined under a table in the regulations.101 Applying this table, the present value of the first note is $9,523,800, and the present value of the second note is $535,400. Accordingly, the total unstated interest in the deferred purchase contract is $9,940,800 (that is, $20 million less $10,059,200, the sum of the present values). Since the deferred payments are $10 million each, this $9,940,800 in total unstated interest is allocated under section 483(a) one half to the first note and one half to the second, despite the fact that virtually all of the imputed interest is in fact attributable to the second payment.

Thus, Buyer, who has paid the economic equivalent of $10 million cash for a nondepreciable asset, will find himself in the serendipitous position of receiving a $4,970,400 interest deduction when he pays off the first note, six months and one day after the purchase. Phrased differently, regardless of whether he is a cash or accrual method taxpayer, Buyer will be able to deduct in the year he makes the first payment almost one half the economic cost of the stock.

If Seller is slothful, Buyer's tax windfall will be Seller's undoing, because Seller will be required to take the same $4,970,400 into income on the payment of the first note. Fortunately, however, Seller has an

100 I.R.C. § 483(c); Reg. § 1.483–1(b)(1). Were the first note to have a maturity of six months or less, like the $250,000 cash payment, it would not be subject to § 483, and the tax results described below would not be obtained. It should be noted that, under section 1.483–1(b)(5) of the regulations, the tax consequences of issuing a single note covering the two payments are the same as issuing two notes.
101 Reg. §§ 1.483–1(c)(1), (g)(2), table vii, column (b).
easy out: If Seller sells the first note within six months of the sale (or within one year of the sale divests himself of the right to all unpaid payments), then, although the analysis is somewhat murky, the result appears to be as follows:

(1) Buyer will be wholly unaffected, and will continue to claim $4,907,400 of interest deduction when the first note is paid.\textsuperscript{103}

(2) In applying section 483 to Seller (but not Buyer), payment on the first note will be deemed received within six months of the sale and thus will not be subject to section 483.\textsuperscript{104} Only the second deferred payment will be subject to section 483, and the total unstated interest on this payment, $9,464,660 ($10 million less $535,400 present value), will be includable in income when the note matures in 30 years.

(3) The acquiror of the first note will be outside the scope of section 483, because, although he will be deemed to have acquired that note in a second deferred purchase transaction, under section 1.483-1(f)(6)(ii)(C) of the regulations, the note will have a maturity on the date he acquires it of less than six months; and section 483 does not apply unless at least one payment is received more than one year after the (in this case, constructive) deferred payment sale.

If the two payment transaction has a flaw, it is its irremediability: It is easy to imagine enough of these transactions being consummated in the near future to invite legislative scrutiny. Under current law, the Service appears to have only relatively weak arguments against them. First, the Service could claim that Seller's transfer of the first note is

\textsuperscript{102} It appears that Seller is protected against adverse tax results if he sells his right to the second payment (whether or not the two payments are incorporated in a single note or two notes) within one year after the property sale even if he has previously been paid the first payment. The argument is that under section 1.483–1(f)(6)(ii) of the regulations, Seller would be retroactively deemed to have sold his property for two payments both due within a year, resulting in no imputed interest and that, under section 1.483–1(f)(4)(ii) of the regulations, he is allowed a deduction for any amount included as unstated interest in respect of the first payment. Also, if the asset sold is not a capital asset in the seller's hands, it is arguable that neither he nor his transferees are subject to § 483, but the buyer nevertheless, determines his interest deduction under that section. See I.R.C. § 483(f)(3); Reg. § 1.483–2(b)(3).

\textsuperscript{103} Reg. § 1.483–1(f)(6)(ii)(a).

\textsuperscript{104} See Reg. § 1.483–1(f)(6)(ii)(b). The reading of this provision suggested in the text requires that, in this context, the phrase "the transferor of the contract right to receive deferred payments shall treat any amount realized . . . from the transferee as the final payment under his [deferred sales] contract" be read as "a final payment." See Murdoch, \textit{Imputed Interest and Section 483, 44 Taxes} 866, 871 (1966). Any other reading, however, appears to render the regulation mechanically unworkable.
merely an assignment of income.\textsuperscript{105} However, this is a highly unlikely recharacterization if the note is an ordinary negotiable instrument and Seller receives fair value for it from an unrelated party. Second, the Service could argue that a prearranged sale by Seller of the first note to a third party should be analyzed as a direct loan to Buyer from that third party, thereby leaving Buyer with only one section 483 payment due in thirty years.\textsuperscript{106} Yet even this argument, which probably requires finding that Seller has acted as Buyer's agent in placing Buyer's short-term note with a third party lender, will prove difficult to sustain, so long as the parties are careful to keep Buyer wholly uninvolved in the resale of his first note, and Seller refrains from arranging for the resale of the first note until a decent period of time has expired following the deferred payment sale. Third, the Service might argue that the sale of the first payment is a bond stripping transaction controlled by section 1232B. That argument is likely to fail since the payment sold is probably not a "coupon" under section 1232B. Finally, the Service might argue that section 1.483-2(a)(ii) of the regulations, which requires that a deduction for unstated interest must be "otherwise allowable," imports the notion that prepaid interest is not currently deductible and permits the Commissioner to invoke his authority under section 446(b) to require accounting which clearly reflects income. While that argument has appeal in terms of permitting an attack on obviously troubling transactions, it must overcome the strong implication that the specific allocation rule contained in the Code is meant to control the issue of timing of interest recognition.

**Debt for Debt Exchanges**

The prior part of this section dealt largely with deferred payment purchases of property that, by evading the economic accrual rules of section 1232A and invoking the mechanical—and often irrational—rules applied to section 483 transactions, permit aggressive taxpayers to accelerate interest deductions while avoiding concurrent income inclusions to the holders. One particular form of such a transaction which has attracted considerable attention is the debt for debt exchange. A debt for debt exchange typically involves a corporate issuer's reacquisition of its debt in exchange for new corporate debt instruments which

\textsuperscript{105} Assignments of income are excluded from the rule recharacterizing a deferred payment sale upon a transfer of a payment. Reg. \S 1.483-1(f)(6)(ii).

\textsuperscript{106} The Service might argue that the seller was required as a practical matter to sell the note in order to avoid inclusion of interest income in respect of the first deferred payment. As indicated supra note 102, however, the seller has a full year to effect the sale. (Indeed the sale can be made even after the first payment is received). Risk of ownership for a full year would seem to rebut the notion that the seller's interest in the note or notes is transitory.
are designed to generate substantial noncash deductions for accruing interest.

In two recent public debt for debt transactions that attracted a great
deal of attention (as well as immediate legislative response), Exxon
Shipping Company and General Motors Acceptance Corporation
(GMAC) retired outstanding indebtedness for new deferred interest
securities of substantially greater principal amount, thereby generating
(or expecting to generate) substantial tax benefits for the issuers.¹⁰⁷
While the Technical Corrections Act of 1982 has foreclosed such
publicly traded debt for debt exchanges in the future, the issues they first
raised appear to still apply to retirements of nonpublicly traded debt
securities through the exchange of newly issued deferred interest securi-
ties that are also not publicly traded. Moreover, many of the questions
raised by debt for debt exchanges under pre-Technical Corrections Act
law are relevant to the analysis of other deferred interest transactions.
Accordingly, this part analyzes debt for debt exchanges under the law
immediately prior to the Technical Corrections Act. For convenience,
the facts of the Exxon Shipping transaction are used as an example.

Exxon Shipping exchanged each $1,000 face amount of old debt
(6% percent notes due in 1998), having a pre-exchange market value
of roughly $650, for 21 new zero coupon obligations due in 30 years.¹⁰⁸
Each zero coupon security had a stated principal amount of $270, and
accrued simple interest at nine percent per annum, thereby entitling a
holder to $730 in interest at the end of 30 years. Since a holder of the
old debt received 21 such obligations for each $1,000 face amount of
old debt, he received $5,670 in stated principal amount of new zero
coupon securities on the exchange, on which interest of $511 will accrue
each year, resulting in an aggregate redemption value at maturity
(stated principal and accrued interest) of $21,000.

Because the exchange was a recapitalization under section 368(a)(1)
(E), it was clear that, under pre-Technical Corrections Act law, the new
securities were not issued with original issue discount. Under section

¹⁰⁷ See Walter, Tax Aspects of Recent Innovative Financings Strategies for
Existing Discount Debt and for New Securities, 60 TAXES 995, 1000–1003 (1982).
For earlier analyses of similar issues, see Spero & Simon, Tax Aspects of Bond
Refundings, 57 TAXES 51 (1979); Lewis, Recognizing Discharge of Indebtedness
Income on Bond-for-Bond Recapitalization, 45 J. TAX 370 (1976).
¹⁰⁸ Exxon Shipping involved a series of direct exchanges of new publicly traded
debt securities for old debt securities which were not publicly traded and which in
many cases were tendered for exchange by their historic owners. If third parties
had acquired the old debt for purposes of consummating an exchange (as in the
GMC exchange offer, which followed the Exxon Shipping transaction and is
discussed in the next section of this article), a question might be raised of whether
they acted as principals or as agents for the issuer, but this question of fact is be-
yond the scope of this article.
1232 as it read prior to the Technical Corrections Act, the issue price of a security issued in a reorganization was deemed equal to its redemption price. Because there was no difference between issue price and redemption price, there was no original issue discount. Moreover, since the new zero coupon securities carried stated interest of nine percent per annum payable at maturity, on their face the new securities met the requirements of the simple interest test rate of section 483.

While Exxon Shipping's intentions are not known, it may be presumed that it or other issuers participating in such bond for bond exchanges intend to deduct the nine percent deferred interest on the new zero coupon securities on a straight line basis, on the theory that such accrual is used to determine the rights and obligations of holders and issuers, respectively, for all relevant purposes. One can also reasonably assume that such issuers intend to amortize on a straight line basis the excess of the principal amount of the new zero coupon securities over the face amount of the old debt on the theory that the excess represents a bond repurchase premium on the old debt. The remainder of this part discusses these theories.

**Deferred Interest**

In attempting to deduct the deferred interest component of its zero coupon securities on a straight line basis, Exxon Shipping must overcome three major hurdles:

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100 I.R.C. § 1232(b)(2); Reg. § 1.1232–3(b)(2)(iii).

110 By its terms, § 483 applies to reorganizations. See, e.g., Reg. § 1.483–1(b)(6) Exs. 4 & 7. In the case of a bond for bond exchange, however, a number of commentators have argued that such transactions should be analyzed, not as an exchange, but as a refunding or substitution of the old debt for the new, in which the new debt is deemed to be issued for an amount equal to the issue price of the old debt (plus accrued discount). See, e.g., Lewis, supra note 107, at 55. Under this analysis, since no sale or exchange occurs, § 483 does not apply. In light of Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942), however, this conclusion seems plainly to be wrong. See also Rev. Rul. 77–437, 1977–2 C.B. 28, and G.C.M. 36602 issued in connection therewith (available on Lexis), holding that the issuance of new lower face amount debt for outstanding debt is an exchange generating cancellation of indebtedness income rather than bond premium.

111 Compare the preliminary prospectus dated August 31, 1982 for the Exxon Shipping Company exchange (interest to accrue for tax purposes at an effective rate of 4.4611 percent compounded annually, but holders' claims on default or a redemption prior to maturity to equal new principal plus interest accrued on a straight line basis) with the prospectus dated September 10, 1982 (straight line accrual of interest for all purposes).

It seems clear that a cash method holder of the new zero coupon securities is not required to include any amount in income with respect to them until their sale or maturity, although the characterization of the amounts so received in part as capital gain and in part as ordinary income is not as certain.
(1) It must establish that the purported stated interest indeed qualifies as such in economic reality and is not discount or unstated interest under section 483.
(2) It must establish that deduction prior to payment properly reflects income under the accrual method of accounting.
(3) It must establish that accrual on the straight line method is appropriate.

Insofar as the first question is concerned, the courts and the Service have long agreed that, for there to be deductible interest, there must be an indebtedness to which the interest relates. Although the instruments issued by Exxon Shipping purport to include components of stated interest as well as stated principal, the apportionment between the two appears to reflect, not the economics of a true borrowing, but an a priori allocation designed to qualify the transaction under the nine percent simple interest test rate of section 483.

The artificiality of the stated division between principal and interest can be seen by examining closely the $5670 of purported principal issued in exchange for each old debt having a $1,000 face amount and a market value of only approximately $650. Normally, a holder of a debt instrument is entitled to the return of his principal upon default. In the case of virtually any obligation other than a nonrecourse loan, the most meaningful event of default is a bankruptcy proceeding. In that respect, the Exxon Shipping prospectus, dated September 10, 1982, for its zero coupon debt for debt exchange contains the following statement:

Limitation on Claims in Bankruptcy

If a federal bankruptcy proceeding were commenced with respect to the Company or the Guarantor, a portion of the claim of a Securityholder in such proceeding with respect to the stated principal amount of each Debenture may be disallowed as interest accruing after commencement of the proceeding. Consequently, such claim in respect of principal could be limited to the consideration initially received by the Company for the Debenture plus accrued amortization of the excess of the stated principal amount over such initial consideration, from the date of issue to the commencement of the proceeding.

Thus, even Exxon Shipping acknowledged the argument that, at least in bankruptcy, the aggregate principal of the new Exxon Shipping zero coupon securities issued in exchange for each $1,000 face amount of

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old debt was not $5,670, but at most $1,000. Since a bankruptcy proceeding is by far the most important arena in which the denomination of amounts as principal has substantive meaning to a creditor, the bankruptcy law analysis should have a direct bearing on this issue for tax purposes. If this analysis is correct, Exxon Shipping will accrue $511 in interest per annum on a true principal amount of $1,000, or interest at a nominal rate of 51.1 percent. If Exxon Shipping had denominated as principal $1,000 of every $21,000 payable at maturity, with interest accruing at the rate of 51.1 percent simple interest per annum, the transaction would have strained observers' credulity, although, as a nontax matter, it would appear to have had the same consequences to holders. Yet, if there is no economic reality to stated principal, correspondingly, there is no economic reality to stated interest.

Since, as a bankruptcy law matter, any stated principal amount above $1,000 for every 21 new zero coupon securities is suspect, and since the stated deferred simple interest rate on $1,000 face amount of new debt would have been so high as to appear ludicrous, it would not be surprising if a court faced with the transaction were to conclude that the purported designations of principal and interest should be ignored, and the transaction treated as a naked promise to pay $21,000 on the 21 new bonds 30 years in the future. Under this approach, Exxon Shipping's interest deduction would be for unstated interest under section 483 and would be allowed when payment comes due at maturity.114

Alternatively stated, the argument would be that Exxon Shipping is attempting to deduct, under the guise of accruing interest, what in fact is discount on the original issue of the bonds and should be deductible prior to maturity only as original issue discount under section 1232A. Section 1.1232-3(b)(1)(iii) of the regulations provides that all amounts, however designated, payable at maturity (except for amounts based on a fixed rate of interest and "actually payable" or "treated as constructively received" at least annually) are parts of the redemption price, and hence are includable in determining original issue discount. Since section 1232, as it read at the time of the transaction, provided that there was no such discount (by defining the issue price of debt issued in a recapitalization as equal to the redemption price), no deduction should be allowed under the guise of accruing interest. This argument is elaborated in connection with the discussion below of deductions for the excess principal amount of the new Exxon Shipping securities.

114 Reg. § 1.1483–2(a)(1)(ii). If the unstated interest rules applied, interest would be calculated at the rate of 10 percent compounded semi-annually. At this discount rate, the promise to pay $21,000 in 30 years would be viewed as consisting of approximately $1,124 in principal and $19,976 in unstated interest.
Even if the stated interest portion of the amount payable at maturity is respected as such, there is some doubt as to its current deductibility. A number of authorities have held that a sufficiently prolonged deferral of a fixed obligation to pay precludes current accrual of the obligation. Thus, in *Mooney Aircraft, Inc. v. United States*, the court considered deductions taken by a taxpayer with respect to amounts payable only upon the retirement of aircraft manufactured by the taxpayer. While the court commented upon the uncertain timing of payment, it also referred to the long deferral (possibly as long as 30 years) of the obligation to pay. The length of the deferral, the court concluded, made current accrual of the deduction a distortion of income that the Service could challenge under section 446(b).

Finally, even if some accrual prior to payment is warranted, accrual on a straight line basis is difficult to defend. Accrual on that basis generates deductions in the first two years of the transaction exceeding the face amount of the retired debt, deductions far greater than the interest accruing on the constant interest method. In attempting to sustain these enormous deductions, an issuer would have to rely on the fact that accrual on a straight line basis is the measure of the amount payable on early retirement. In that connection, it is instructive to consider the economic viability of the new securities’ call features.

In the following chart, the second column sets out the growth of accrued principal on an Exxon Shipping zero coupon obligation on a constant interest basis (the method that would have been required had section 1232A applied to the transaction), from the approximate market value of the old debt ($650) to the amount payable in 30 years ($21,000). The next column shows the amount that Exxon Shipping

<table>
<thead>
<tr>
<th>Year After Issuance</th>
<th>Constant Interest Accrued Principal ($650 at 12.28% compounded annually)</th>
<th>Optional Redemption Price ($5,670 times 9% simple interest)</th>
<th>Current Yield to Maturity of Optional Redemption Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>$1,160</td>
<td>$8,225</td>
<td>3.25%</td>
</tr>
<tr>
<td>10</td>
<td>2,070</td>
<td>10,780</td>
<td>3.39%</td>
</tr>
<tr>
<td>15</td>
<td>3,690</td>
<td>13,335</td>
<td>3.07%</td>
</tr>
<tr>
<td>20</td>
<td>6,590</td>
<td>15,890</td>
<td>2.83%</td>
</tr>
<tr>
<td>25</td>
<td>11,760</td>
<td>18,445</td>
<td>2.63%</td>
</tr>
<tr>
<td>29</td>
<td>18,690</td>
<td>20,489</td>
<td>2.49%</td>
</tr>
<tr>
<td>30</td>
<td>21,000</td>
<td>21,000</td>
<td>—</td>
</tr>
</tbody>
</table>

115 420 F.2d 400 (5th Cir. 1969). *See also supra* note 89 and accompanying text.

116 The yield to maturity is slightly greater than 12 1/4 percent. If the column were instead based on the face amount of the old debt ($1,000), the results would not be materially different.
would be required to pay to retire the new debt under its optional redemption provisions. The right-hand column shows prevailing market yields to maturity that would be required for each year in question if the Exxon Shipping zero coupon instruments were to trade at their optional redemption price—that is, the prevailing yields to maturity at which the optional redemption would be financially feasible.

If Exxon Shipping were to accrue its deferred interest on a straight line basis, a court should give no weight to the obligations' prepayment feature, given how unrealistic it is financially to expect that the feature will ever be utilized. Because there is no realistic possibility that interest measured on a straight line basis will be paid prior to maturity, a court—if it does not simply apply the unstated interest rules of section 483 or the original issue discount preemption argument under section 1232—should allow accrual only on the TEFRA-sanctioned yield to maturity basis.

**Excess Principal Amount**

We now examine Exxon Shipping's right to deduct the excess of the nominal principal amount of the new debt ($5,670) over the $1,000 face amount of old debt retired in exchange therefor. At first glance, it would appear that a deduction for this excess is merely a back door approach to deducting original issue discount, preempted by section 1232 as it read at the time. However, several old cases have held that when old debt securities are retired in exchange for new debt securities, unamortized discount on the old securities, redemption premiums payable in accordance with the old securities' terms, or premiums attributable to the enhanced value of old securities derived from a conversion feature could not be deducted, as the taxpayers in each case claimed, at the time of the debt for debt exchange (as would have been the case had the old debt securities been retired for cash). Instead, these premiums were treated as costs of issuing the new securities, and were therefore allowed, not as current deductions, but rather ratably over the life of the new securities.117 Examination of these cases reveals, however, that they are really discount cases which were implicitly overruled by the 1969 amend-

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117 Southwest Grease & Oil Co. v. United States, 435 F.2d 675 (10th Cir. 1971) (premium attributable to enhanced value of old debt, which was convertible, retired in exchange for cash and 6 percent nonconvertible debentures); Great Western Power Co. v. Commissioner, 297 U.S. 543 (1936) (cash premium required by indenture governing old bonds to be paid upon exchange for new bonds). See also South Carolina Continental Tel. Co. v. Commissioner, 10 T.C. 164 (1948) (purported sale of new 4% bonds and use of proceeds to redeem 5% bonds treated as integrated exchange of equal principal amounts of bonds; premium paid in accordance with their terms upon retirement of old bonds must be amortized over life of new bonds). See Lewis, supra note 107, at 371–73.
ments to section 1232 which preclude the creation of discount in reorganization transactions.

In *Great Western Power Co. v. Commissioner*,\(^ {118} \) for example, a corporation had outstanding debt instruments (General Lien 8’s) which had been issued at a small discount from face and with moderate issue expenses. When the corporation called the General Lien 8s, some holders elected to receive in exchange new obligations of equivalent face amount (Series B7’s) and $50 cash per old bond. The issuer attempted to deduct in the year of the exchange (1) the $50 cash premiums paid to exchanging debt holders, (2) conversion expenses, and (3) the remaining unamortized discount and issue expenses attributable to the General Lien 8’s that were exchanged for Series B7’s. The Supreme Court rejected the taxpayer’s contention that those expenses should be immediately deductible, as they would have been had the old securities been retired for cash:

The question is whether, upon an exchange of one obligation for another which is to be retired, the transaction is to be viewed as if the retirement were accomplished by the payment of cash. If the retired bonds had not been called, the expense items incurred in connection with their issuance would properly be amortized over the remainder of their life. The remaining unamortized expenses of issue of the original bonds and the expense of the exchange are both expenses attributable to the issuance of the new bonds and should be treated as part of the cost of obtaining the loan. They should, accordingly, be amortized annually throughout the term of the bonds delivered in exchange for those retired.\(^ {119} \)

In *Great Western*, there was no claim that the new securities were issued at a discount. The Court merely held that discounts on the Old General Lien 8’s should continue to be amortized as unamortized discount on the new Series B’7s of equivalent face amount. In the process, the Court rejected the taxpayer’s argument that it was entitled to an immediate deduction because it should be in the same position as if it had retired its old debt for cash. (Under that theory, of course, Exxon Shipping would recognize cancellation of indebtedness income, coupled with original issue discount on the new debt, because the fair market value of the new Exxon Shipping zero coupon securities was substantially less than the face amount of the old debt retired in exchange therefor.) In *Missouri Pacific R.R. Co. v. United States*,\(^ {120} \) however, the Court of Claims explicitly concluded that in a pre-1969 debt for debt exchange where the face amount of the new debt securities exceeded

\(^{118}\) 297 U.S. 543 (1936).
\(^{119}\) Id. at 546–47.
\(^{120}\) 427 F.2d 727 (Ct. Cl. 1970).
the face amount of the old, the excess was debt discount amortizable over the life of the new debt.\textsuperscript{121}

The legislative history of the Tax Reform Act of 1969 strongly suggests that no deduction should be allowed in respect of Exxon Shipping's excess principal amount. The Tax Reform Act of 1969 amended section 1232 to provide for the first time that debt instruments issued pursuant to a plan of reorganization do not give rise to original issue discount. Subsequently, section 1.163-4 of the regulations was promulgated, which permits issuers to amortize original issue discount, as that term is defined in section 1232, reflecting the purpose of the 1969 amendments to achieve consistency of treatment between bondholders and issuers with respect to original issue discount. The 1969 legislative history states that the pre-1982 rule that no original issue discount is created when an obligation is issued in a reorganization was adopted to prevent acquiring corporations in acquisitive reorganizations from claiming low values for their debt issued in the exchanges, thereby generating original issue discount at no cost to themselves, because the basis of the acquired assets in the acquirors' hands would be determined under the carryover basis rules of section 361.\textsuperscript{122}

Accordingly, a strong argument can be made that the legislative intent of the 1969 changes was that debt discount is amortizable only to the extent it is original issue discount under section 1232, and that section 1.163-4 of the regulations should be read as a preemptive prohibition against the amortization under any guise of issue discount not constituting original issue discount, rather than a license to deduct such amounts under alternative theories. In the context of debt instruments issued in a reorganization for stock, for example, courts have in fact construed the 1969 amendments to be preemptive and have rejected the argument that ratable amortization theories not expressly incorporated in section 1232 and 163 survived the 1969 amendments.\textsuperscript{123}

Putting together the earlier case law with the purpose of the 1969 amendments suggests that the excess of new principal amount over old constitutes issue discount under \textit{Missouri Pacific}, and that Exxon Shipping is not entitled to any current deduction with respect to that discount.

\textsuperscript{121} See also \textit{Natural Gas Pipeline Co. v. Commissioner}, 45 B.T.A. 939 (1941).
\textsuperscript{122} The original version of the 1969 Act did not contain an exception for debt for property or reorganization exchanges. At the last minute, Treasury became concerned about the valuation problem described in the text, as well as a potential for whipsaw between buyer and seller in debt for property exchanges, and urged changes that were reflected in the law until 1982. The Treasury letter setting out its analysis is contained in \textit{Series IV Primary Sources (BNA)} § 1232 at 19–20. See also G.C.M. 36602, \textit{supra} note 110.
\textsuperscript{123} See \textit{Seaboard Coffee Serv., Inc. Commissioner}, 71 T.C. 465 (1978), which explicitly holds that § 1232 and § 1.162–4 of the regulations are preemptive.
If and when the new debt is paid off, Exxon Shipping should be allowed a deduction either under section 165 (as a loss) or under section 163 (as debt repurchase premium). Such a deduction would be concurrent with gain or income recognition on the part of an original holder, which is consistent with the purpose of section 1232.

Technical Corrections Act

Legislative History

The Exxon Shipping transaction described above was followed by an exchange by GMAC of new zero coupon debt for outstanding debt. The exchange was effected with an investment banker, which had acquired the old debt and resold the new debt to the public after the exchange. The GMAC transaction created obvious consternation in the Service and Treasury Department. Perceiving the possibility of massive revenue losses, the government acted with unusual speed to curb what it regarded as an end run around the original issue discount rules as revised by TEFRA.

The prospectus for the GMAC exchange was dated December 2, 1982. The government's reaction to it is summarized in the following excerpt from the supplement to the prospectus dated December 15, 1982:

During the week of December 6, 1982, senior officials of the IRS and The Treasury Department communicated to the Company and the Selling Securityholder the intention of the IRS to challenge this transaction if any basis for doing so can be found under existing law. They advised that no grounds for challenge had yet been identified, except that on audit they would examine the possibility that the Debentures were issued with original issue discount because the exchange was not a recapitalization within the meaning of Section 368(a)(1)(E) of the Internal Revenue Code of 1954, either on the ground that the Selling Securityholder might be determined to have acted as agent of the Company or for other reasons.\(^\text{124}\)

At the same time that the government was making administrative inquiries into the GMAC transaction, causing considerable disruption in the marketing of that offering, it moved to thwart future transactions along the same lines by statutory amendment. It sought and obtained an addition to the Technical Corrections Bill, then being considered by Congress, which made far reaching changes in section 1232. The changes are effective with respect to evidences of indebtedness issued after December 13, 1982, except for those issued pursuant to written commitments binding on that date and at all time thereafter.

\(^{124}\) General Motors Acceptance Corp., Prospectus Supplement 1 (Dec. 15, 1982).
Section 306(a)(9)(C)(i) of the Technical Corrections Act eliminated the following parenthetical clause in section 1232(b)(2): "(other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or an insolvency reorganization within the meaning of section 371 or 374)." The deletion of the parenthetical clause, which had been relied upon as eliminating original issue discount in the Exxon Shipping and GMAC transactions, subjected debt instruments issued in a reorganization (including a recapitalization) to the normal section 1232 rules for debt issued for property. Under the normal rules, original issue discount may arise on the issue of an obligation in exchange for property if (1) the debt is part of an issue a portion of which is traded on an established securities market or (2) it is issued for stock or securities traded on such a market. In either of the described circumstances, the debt is deemed to have been issued at an issue price equal to the fair market value of such traded debt or of the traded stock or securities exchanged for such debt. The difference between this issue price and the stated redemption price at maturity may be original issue discount under section 1232(b)(1). If the debt is neither traded nor issued for traded stock or securities, the issue price is deemed to be the stated redemption price at maturity, thereby precluding original issue discount.

Had the Technical Corrections Act made only this change in the section 1232 rules, the result would have been to revive the interpretative question, which existed under section 1232 prior to the inclusion of the above-noted parenthetical language, relating to the measure of original issue discount in recapitalization and other reorganization exchanges where the fair market value of the debt issued was less than the original issue price of the stock or debt reacquired. That confusing question under pre-1969 law was avoided, however, through the addition of a new subsection in section 1232, which creates a deemed issue price in bond for bond exchanges, but not other reorganization exchanges, equal to the issue price of the old debt retired in the exchange increased by any previously amortized original issue discount. If the old bonds in the Exxon Shipping transaction had been issued at $1,000,


126 Section 1232(b)(4) now provides:

Special rule for exchange of bonds in reorganizations.
(A) In general.—If—
       (i) any bond is issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) for another bond (hereinafter in this paragraph referred to as the "old bond"), and
the difference between this amount and the amount payable on the maturity of the obligations issued in exchange, $21,000, would have been original issue discount if the new rules had applied to it.

The Conference Report on the new enactment describes the tax consequences of transactions structured along the lines of the Exxon Shipping and GMAC offerings after TEFRA but before passage of the Technical Corrections Act.

New obligations exchanged for a corporation's outstanding obligations in a recapitalization may provide for the deferral until maturity of payments exceeding both the issue price of the outstanding obligations and their fair market value at the time of the exchange. Such deferred payments are not within the definition of original issue discount and are not taxable to a holder under the original issue discount rules of section 1232A. Some issuers have claimed entitlement to deductions prior to payment and without regard to the limitations that would apply if such deferred amounts were original issue discount. The claimed treatment would produce a substantial mismatching between the timing of the issuer's deduction and the holder's income inclusion, producing a substantial revenue loss to the Treasury. Present law is unclear as to the proper treatment of such amounts.127

The report also contains the following description of the proposed change:

The conference agreement follows the House amendment with a modification under which the adjusted issue price of an old bond exchanged in the transaction, for purposes of determining the limitation on original issue discount to the holder, is the issue price of such bond increased by the portion of original issue discount previously includible in the income of any holder. The conferees do not intend to create any inference as

(ii) the fair market value of the old bond is less than its adjusted issue price,
then for purposes of the next to the last sentence of paragraph (2), the fair market value of the old bond shall be treated as equal to its adjusted issue price.

(B) Definitions.—For purposes of this paragraph—

(i) Bond. The term “bond” includes any other evidence of indebtedness and an investment unit.

(ii) Adjusted issue price.—

(1) In general. The adjusted issue price of the old bond is its issue price, increased by the portion of any original issue discount previously includible in the gross income of any holder (without regard to subsection (a)(6) or (b)(4) of section 1232A (or the corresponding provisions of prior law)).

(II) Special rule of applying section 163(e). For purposes of section 163(e), the adjusted issue price of the old bond is its issue price, increased by any original issue discount previously allowed as a deduction.

to the timing of deductions for deferred interest payments allowable to an issuer of an obligation that is not considered as issued at a discount under section 1232(b)(2). The conferees understand that the Treasury Department is currently studying the question of whether deductions for deferred interest payments under obligations that are not considered as issued at a discount [under Section 1232(b)(2) can be deducted under present law prior 128] to the inclusion of the deferred interest in gross income by the holders of such obligations. In the event that the mismatching of income and deductions in transactions not covered by the conference agreement cannot be satisfactorily resolved under present law, further corrective legislation may be appropriate in the near future to prevent such mismatching.129

Interpretative and Policy Issues Raised by the Technical Corrections Act

The changes made by the Technical Corrections Act effectively eliminated the benefits of future Exxon Shipping and GMAC type transactions involving publicly traded securities. Where a new zero coupon debt instrument is issued for outstanding debt or stock of the issuer and the securities issued or reacquired are traded, discount on the new instrument may be generated and taxed consistently to the holder and issuer under the new post-TEFRA economic accrual rules.130 Thus, the creation of accrued interest, arguably deductible by the issuer and not includable by cash method holders, is effectively precluded as to publicly traded securities.

Moreover, by establishing a deemed issue price for a new bond issued for an old bond in a reorganization equal to the issue price of the old bond increased by previously amortized original issue discount on the old bond, the statute has effectively precluded the conversion of market discount on the outstanding debt into original issue discount. At the same time, it prevents recognition of original issue discount and cancellation of indebtedness income where bonds of equal face amount are exchanged. Thus, if outstanding publicly traded debt securities of Company X had originally been issued for $100, but were trading for $60 at the time of a recapitalization exchange in which a new $100 security of Company X was issued, in the absence of the bond for bond

128 The material in brackets does not appear in published versions of the Conference report but was included in the typed version of that report as sent to the Government Printing Office.
129 CONF. REP., supra note 127, at 21 n.105.
130 The impact of this change apparently was not immediately evident to some issuers, which put out offering documents relating to preferred stock exchangeable at the issuer’s option for its own debt obligations without mentioning the risk that such debt obligations might bear original issue discount. See, e.g., Boise Cascade Corporation, Preliminary Prospectus (Jan. 17, 1983) (dealing with convertible exchangeable preferred stock).
rule, the issue price of the new debt would be $60, generating $40 of original issue discount to be amortized over the life of the new bond. In such a case, the issuer would probably have had cancellation of indebtedness income. The bond for bond rule effectively eliminates that conversion of market discount into original issue discount in a simple bond for bond exchange by deeming the new debt to be issued for $100.

While the language and operation of the new rules seem clear enough, their application in particular circumstances raises certain technical problems. The interpretative questions raised by the new statute are discussed below, followed by a discussion of certain policy issues raised by the inconsistent treatment of traded and nontraded obligations. This section concludes with a legislative proposal designed to cure this disharmony, as well as the others previously analyzed in this article.

**Interpretative Issues**

While most of the interpretative questions relate to the manner in which the bond for bond rule operates, some questions are generated simply by the removal of the recapitalization exception from the original issue discount rule.

By eliminating the recapitalization exception, the Technical Corrections Act has transposed to debt for debt exchanges the redemption premium issue that has been a subject of concern where redeemable preferred stock is used by a corporation in a self tender for its own common stock (or in an acquisitive reorganization). To see the problem in the context of a preferred stock transaction, assume a corporation, whose common stock is trading for $60 per share, wishes to reacquire 20 percent of its stock at a price of $70 per share. The premium of $10 per share is deemed by the company essential to assure a successful self tender in these circumstances. If the corporation had simply issued preferred stock, bearing a market dividend rate, for $70 and used the cash to redeem its common stock at a premium over market, the preferred stock would not have borne redemption premium under section 305. However, if the same preferred stock is used in the self tender, it is at least arguable that a redemption premium is created under section 305. Such a premium, to the extent it exceeds a reasonable redemption premium, must be amortized as dividend income over the period from issue date to date of first possible redemption.\(^{131}\)

Transposing this situation to a case where traded common stock is

\(^{131}\) Reg. § 1.305-5(b). In the past, some issuers have attempted to avoid this and similar problems in acquisitive reorganizations by making the preferred stock immediately redeemable. The Service has ruled on a number of occasions that such an immediate redemption precludes the possibility of an amortizable redemption premium.
acquired for nontraded debt, whether or not constituting a security for purposes of section 354, the possibilities exist for creating original issue discount where none exists as an economic matter. Thus, if the company were to issue nontraded debt having a face amount and fair market value of $70 for its outstanding traded common stock, then trading at $60, the issue price of the debt would be the trading value of the stock for which it was exchanged.132 The result would be even more serious than in the case of the preferred stock transaction previously described since there is no exception for a reasonable original issue discount other than the de minimis exception provided in section 1232 (b)(1) (1/4 of one percent times the number of years to maturity). It would be particularly appropriate for the Service to reconsider the proper measure of fair market value in these circumstances. In particular, the Service should hold that the fair market value of the stock acquired, and thus the issue price of the debt or preferred stock issued, should be $70 in the examples, rather than $60.

A second issue raised by the elimination of the reorganization exception relates to the case where new debt is issued for old debt where the new debt has a fair market value greater than the issue price of the old debt (plus previously amortized discount). Assume for example that issuer had issued at par in 1983 a ten-year bond paying $100 at maturity. In year 10, issuer retires the old bond in exchange for a new bond worth $120, but with a face amount of $200. The bond for bond floor rule does not come into play since the fair market value of the new debt exceeds the issue price of the old debt. Accordingly, it would appear that original issue discount of $80 would be amortized on the new debt. The open question, however, is the treatment of the $20 excess of the fair market value (and issue price) of the new debt over the issue price of the old debt. Presumably, that excess should be allowed as a bond redemption premium deduction in respect of the old debt for the year of the exchange. This would be consistent with the result which would obtain if the new debt was sold to third parties for $120 and the proceeds used to redeem the old debt at a premium, a characterization which appears implicitly to have been adopted through the elimination of the reorganization exception from section 1232. It would, however, be contrary to the approach taken in the Great Western Power and Southwest Grease cases previously discussed.133

132 Reg. § 1.1232-3(b)(2)(iii)(c). If the debt issued were itself traded, in contrast, the issue price of the debt would be its fair market value as established by trading. Id.
133 Supra note 117. See G.C.M. 36602, supra note 110 (discussing the Southwest Grease case and supporting the analysis in the text).
The remaining interpretive issues under the Technical Corrections Act relate primarily to the new bond for bond rule. As noted above, the evident purpose of that rule is to create a floor on the deemed issue price of bonds issued in a reorganization. By strong implication it precludes the assertion of such a floor in other reorganization exchanges, such as redemptions of preferred stock for long-term debt. However, the limited application of the floor rule to bonds issued in a reorganization for other bonds, and the language of the provision itself, all raise serious interpretive questions.

First, the application of the bond for bond rule is unclear where a package of consideration consisting of a new bond and cash or other property is issued in exchange for an old "bond" in a reorganization exchange. The term "bond" is defined in new section 1232(b)(4)(B)(i) to include "any other evidence of indebtedness and an investment unit." Accordingly, if an investment unit consisting of stock worth $10 and debt worth $50 but having a face amount of $100 were issued for outstanding issuer debt (constituting a security under section 354 of the Code) with a face of $100 and a fair market value of $60, the application of the bond for bond rule runs into certain internal contradictions. As a first step, the statute would seem to provide that the issue price of the new investment unit would be $100, the issue price of the old bond. Presumably, that issue price would be allocated between the elements of the investment unit in accordance with their relative fair market values, generating original issue discount on the new bond. However, the bond for bond rule could be read as providing that, since the new bond itself is issued for the old bond, its issue price is the issue price of the old bond, thus generating an issue price of $100 and no original issue discount. While the question is not free from doubt, it would appear that the better rule would be to treat $100 as the issue price of the unit and allocate that issue price between the elements of the unit in accordance with their relative fair market values.

By modifying the foregoing example slightly to provide that the package issued in exchange for the old debt consists of new debt with a face of $100 worth $50 and cash of $10, the results might be varied materially. A package of new debt and cash issued in such a transaction probably would not be treated as an investment unit under section 1232(b)(2) of the Code. Accordingly, it would not be possible to argue that the bond for bond rule should be interpreted as allocating $100 to

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134 Although section 1.1232–3(b)(2)(ii) of the regulations could possibly be read as extending the statutory definition of investment unit to include such a package.
the package of cash and debt pursuant to its terms. Thus, the argument might be raised that the new debt has an issue price of $100 (the issue price of the old debt) and that $10 of cash was received in addition. This would preclude the deduction of original issue discount on the new debt. Under the existing section 1232 regulations, the issue price of the new debt would also be the amount realized by the transferor in the transaction. Thus, the transferor would arguably be deemed to have realized $100 in respect of the new debt received plus $10 in respect of the cash received. Since he would have received $10 of nonqualifying consideration, he would be required, under this theory, to report $10 of taxable gain even though he has an economic loss in the overall transaction. This is, of course, an absurd result. The bond for bond rule should be interpreted in these circumstances to provide that the $10 represents a part payment of the old debt. The bond for bond rule should then be applied to treat the new debt as having been issued for $90 of old debt at an issue price of $90, generating $10 of original issue discount.

An ancillary question raised by debt for debt exchanges under the new provisions relates to the possible creation of cancellation of indebtedness income. Assume, for example, that a corporation has an outstanding $100 bond having a fair market value of $60. Further assume that the bond is exchanged for a new $100 debt worth $50 plus $10 worth of other consideration (neither cash nor stock of the corporation in question). If one assumes that the bond for bond rule will be interpreted to provide that $100 is the issue price of the investment unit and that such issue price should be allocated between the elements of the package, the new debt will presumably be deemed to have been issued for $83.33 of old debt ($50 divided by $60 times $100) and the other property would be deemed to have been transferred in cancellation of $17.67 of old debt ($10 divided by $60 times $100). It is arguable in these circumstances that the issuing corporation has, in addition to original issue discount of $17.67 amortizable on the new debt, cancellation of indebtedness income measured by the excess of the debt satisfied by the transfer of the other property over the fair market value of such other property ($17.67 minus $10 = $7.67). (There would also presumably be gain or loss measured by the difference between $10 and the corporation's basis in such other property). This problem would not exist if issuer stock were used in this example since the "stock for debt" rule referred to in section 108(e)(8) of the Code would presumably preclude debt cancellation income (assuming that the de minimis test contained in that section were satisfied), and section 1032 would preclude corporate gain recognition on the stock issuance.
The limited scope of the new bond for bond rule also creates possibilities of inconsistent results and manipulation. As previously noted, the bond for bond rule only applies to debt securities issued in a reorganization. Accordingly, in the case of corporations attempting to convert market discount into original issue discount, there will be an incentive to structure the transaction as not a reorganization so as to avoid the bond for bond rule. One way to achieve this result would be to characterize the old debt as not a security or to issue new debt not qualifying as a security. Another way would be to issue debt of a related entity (the parent or a subsidiary) not qualifying for nonrecognition treatment under section 354. In such cases, the bond for bond rule would presumably not apply. This result maintains the conflict in interest under old law between issuers attempting to characterize a transaction as not a reorganization and exchanging holders trying to fit within that rubric.

Through these techniques, the corporation might be able to generate original issue discount in such an exchange. As an offset, the corporation might also have cancellation of indebtedness income in some circumstances (subject to the ability to exclude that income by electing to reduce the basis of depreciable assets pursuant to section 108(c)). A case where original issue discount might be generated without creating cancellation of indebtedness income would be an acquisition of $100 face amount outstanding debt worth $80 (not constituting a security under section 354) for $100 face amount new traded debt worth $40 (whether or not a security) plus issuer stock worth $40. Since the old debt is not a security, the bond for bond rule would not apply and $60 of original issue discount would be created, but there arguably would not be cancellation of indebtedness income because of the stock for debt rule.

Broader Policy Issues Raised by the Technical Corrections Act and a Proposed Legislative Solution

The major policy issue raised by the change in section 1232 made by the Technical Corrections Act relates to the inconsistency in treatment

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135 In that connection see, however, § 108(e)(4) (treating acquisitions of outstanding debt by a party related to the debtor as an acquisition by the debtor for purposes of the cancellation of indebtedness rules).

136 See 3 Bond Week 4 (Jan. 31, 1983) (dealing with original issue discount questions raised by the acquisition of Cities Service by Occidental Petroleum).

137 If the old debt constituted a security, the discount on the new debt would presumably be $50 (i.e., $100 presumed issue price for the investment unit × 40/80 = $50, which, when subtracted from $100 payable at maturity, generates $50 of discount).
between transactions in which publicly traded debt is issued (or in which publicly traded stock or debt is redeemed) and those in which both the debt issued and the stock or debt redeemed are privately held. It is understood that some advisors are counseling corporate clients that transactions structured along the lines of the Exxon Shipping and GMAC transaction can still be undertaken where publicly traded instruments are not involved. Based upon the discussion of possible attacks on such transactions under the law prior to the Technical Corrections Act discussed above, taken in the light of the very strongly worded legislative history of that Act, there is some cause for caution. Nevertheless, where the stakes are as high as they are in this context, taxpayers will undoubtedly take considerable risk. The mere possibility that the Service might raise and sustain an attack on this form of transaction will probably fail to deter many corporate issuers who see the possibility, in effect, of issuing zero coupon debt, the discount on which is arguably deductible on a straight line basis and not required to be included in income by cash method holders until maturity.

The legislative history of the Technical Corrections Act makes it clear that Congress intends to monitor this situation and to enact additional legislation in the event that this perceived loophole continues to be exploited. It also demonstrates the need for broad scale revision of the tax rules in this area to provide consistent results. Certainly, in terms of tax policy, the loophole is equally objectionable where publicly traded or privately held instruments are involved. For reasons of consistency among taxpayers, as well as to further the tax policy manifested by the recent change in the Technical Corrections Act, the provisions of section 1232 should be further modified.

The basic question is whether the modification in section 1232 should relate only to debt for debt type transactions or should extend section 1232 to all debt for property transactions. We believe that a broad scale extension of section 1232 is needed both to cure existing abuses and to avoid spawning new ones. While it might be argued that debt for debt transactions are particularly objectionable because they merely reschedule the capital structure of a corporation and, in the process, purport to create deductions without corresponding concurrent inclusion in income, analogous transactions involving other property for debt exchanges are really quite as objectionable. Consider, for example, the case of the sale-leaseback tax shelter previously described in which the accrual method partnership issues a note bearing a high rate of interest which accrues but need not be paid for a number of years. As previously described, the likely effect of that transaction is to accelerate issuer deductions (in many cases making them recoverable at a rate even quicker than the ACRS period for the underlying property) without the con-
current inclusion in the cash method taxpayer's income. Indeed, as also noted above, the manipulation is often magnified by generating deductions for accruing rent on the related leaseback (a cash method sandwich corporation being interposed to insulate an accrual method seller from an accrual method buyer). Finally, the authors understand that tax opinions issued in some tax shelter offerings assert that the Technical Corrections Act, by making only limited changes in section 1232, effectively abrogated the rule of Estate of Franklin v. Commissioner \(^{138}\) to the effect that nonrecourse purchase money mortgages are not included in basis except to the extent supported by the property's value at the time of purchase.

The correct approach, and one which we believe will ultimately be adopted, is to extend the economic accrual concept of section 1232A to virtually all transactions, including, in particular, transactions in which debt is issued for property whether or not that property is traded. In effect, the amplified section 1232A would displace section 483, would require computation of interest on a true economic basis, and would require consistency in treatment between holder and issuer. Under this approach, section 1232 would apply to debt issued by individuals as well as entities. In one stroke, this change would rationalize the treatment of the two payment section 483 transaction, the nine percent simple interest capital gain conversion, and the privately held debt recapitalization in the mode of Exxon Shipping. Moreover, with some modification in the regulations under section 1232, the section as revised would also provide correct results for reporting income and deduction in accruing interest real estate tax shelters and for distinguishing between interest and principal in installment loan transactions.

Obviously, where neither the property acquired nor the debt issued is traded, some valuation problems are bound to exist. These problems can be minimized, however, if the new section 1232A fixes as the issue price of nontraded debt issued for nontraded property the presumed fair market value of the debt. The presumed fair market value at the time of issuance could be defined by reference to a table published by the Service that would group obligations of different maturities into brackets of comparable maturities, and that would then refer to a regularly published source showing the yield to maturity of Treasury securities of varying maturity.\(^{139}\) Referring to Treasury securities will, if anything,
understate the discount. Since current law has the effect of preventing the creation of discount in such exchanges, no one should be heard to complain that an index which creates discount in such circumstances, but perhaps understates it, is a distortion.

Several modifications would probably have to be made in the new section 1232A in light of its expanded scope. First, even with the index mechanism, it probably would not be sensible to apply the expanded section 1232A to transactions below a certain dollar threshold involving property not held for the production of income or in a trade or business. Thus, the sale of a residence for deferred payments should generally not give rise to discount required to be included on the accrual method by the seller. The excluded transactions described above could be brought within section 483, which would remain only for the purpose of covering transactions excluded from the expanded section 1232A.

Changes should also be made in the definition of stated redemption price at maturity presently included in section 1.1232-3(b)(1)(iii) of the regulations. First, that section should be amended to make it clearly applicable to installment loans (in effect, treating them as serial maturity obligations). In this fashion, economic accrual concepts would displace the present confused case law and rulings in this area. Second, the regulation should be amended to cover the accruing interest tax shelter example described above. Under that regulation as it currently reads, an amount based upon a fixed rate of simple or compound interest which is actually payable or will be treated as constructively received at fixed periodic intervals of one year or less is treated as not included in the stated redemption price at maturity. Excluding periodic interest in this fashion prevents the original issue discount rules from applying to a normal bond with periodic interest payments (although, as noted above, applying those rules to such bonds would not alter the measure of interest accruing each period). But for this provision, the regulation could be read as treating such a bond as a series of minibonds, each interest payment constituting a minibond and the final maturity payment constituting an additional minibond. Under section 1232A, such a series of minibonds would be deemed to bear original issue discount in the amount of the aggregate interest payments. The purpose of the regulation is to prevent invocation of the complexities of the original issue

lists the weekly average yield of Treasury notes and bonds with the following maturities:

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Yield</th>
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<tbody>
<tr>
<td>1 year</td>
<td>7 years</td>
</tr>
<tr>
<td>2 years</td>
<td>10 years</td>
</tr>
<tr>
<td>2½ years</td>
<td>20 years</td>
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<td>3 years</td>
<td>30 years</td>
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<td>5 years</td>
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</tbody>
</table>
discount rules where interest will be taken into income and deducted, both by cash and accrual method taxpayers, at least annually. This purpose is frustrated in arrangements in which interest accrues but is deferrable by the obligor without consequence. Accordingly, the regulation should be modified to provide for an exclusion of annual interest from the stated redemption price at maturity only if the payment thereof is unconditional.\(^{140}\)

As thus extended, the new section 1232A will provide economic and consistent treatment for borrowing, deferred purchase and recapitalization transactions. Having rationalized the law as to these transactions, Congress should consider whether similar rules should not be enacted to cover other deferral transactions. For example, it can be provided that deferred rent arrangements, where one party accrues rent as a deduction but does not pay it for a number of years, should be brought under similar rules. Another example would be to provide that accrued obligations to make future payments or render future services, if deductible as accrued, should be deductible only in an amount equal to their present value, as determined by reference to Treasury bond tables of the type described above. A similar rule could be adopted for deferred income items. While the list of possible logical analogies to the new section 1232A is long, that should not deter Congress from taking this very important first step.

\(^{140}\) Another unrelated change which probably should be made in the § 1232 regulations is to amend section 1.1232–2(b)(2)(ii)(b) of the regulations, dealing with agreements as to the issue price of debt issued as part of a nontraded investment unit, to eliminate the implication that unreasonable allocations are permissible so long as they do not overstate the original issue discount on the debt.