Calendar No. 185

99TH CONGRESS
1st Session

SENATE

REPORT
99-83

SIMPLIFICATION OF IMPUTED INTEREST RULES

JUNE 13 (legislative day, JUNE 3), 1985.—Ordered to be printed

Mr. PACKWOOD, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 2475]

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance, to which was referred the bill (H.R. 2475) to amend the Internal Revenue Code of 1954 to simplify the imputed interest rules of sections 1274 and 483, and for other purposes, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

I. SUMMARY

Present Law

The Deficit Reduction Act of 1984 (the "1984 Act", P.L. 98-369) made two basic modifications to the Federal income tax treatment of interest on seller-financed obligations arising from the sale of property. First, the 1984 Act attempted to correct deficiencies in the then existing imputed interest rules by providing that the amount of unstated interest in a transaction would be determined by reference to an interest rate tied to the yields on U.S. Treasury obligations. Under the imputed interest rules as modified by the Act, if interest is not stated at a rate at least 110 percent of the "applicable Federal rate"—the average yield on Treasury obligations within an appropriate category of maturities—then interest is imputed into the transaction at a rate equal to 120 percent of the Federal rate. The effect of imputing interest income into a transaction is not to increase the amount paid by the buyer to the seller over the term of the loan, but to recharacterize a portion of the

51-010

payments (designated as principal by the parties) as interest for Federal income tax purposes.

Second, the 1984 Act expanded the rules dealing with original issue discount to cover many deferred-payment obligations arising from the sale of property. The purpose of this change was to ensure that the interest deduction taken by the buyer during a year essentially equals the amount of interest income reported by the seller during that year.

The 1984 Act also modified the tax treatment of certain loans with below-market interest rates, other than those subject to the imputed interest rules. Generally, the 1984 Act would treat such "below-market loans" as loans bearing a market rate of interest, accompanied by a payment from the lender to the borrower.

In response to concerns expressed about the complexity of the 1984 Act rules, the Congress passed temporary legislation (called the "stopgap legislation", P.L. 98-612) at the end of the 98th Congress. Under the stopgap legislation, in seller-financed transactions the test rate on the first $2 million of borrowed amounts is 9 percent on sales and exchanges of property occurring before July 1, 1985.

Committee Bill

Imputed interest rules

The Committee bill provides that the rate used to test the adequacy of stated interest on the first $2 million of seller financing cannot exceed 9 percent. Where the amount of seller financing is greater than $4 million, that rate is 100 percent of the applicable Federal rate. Where the amount of seller financing is between $2 million and $4 million, that rate is a blend of the 9 percent rate on an amount which phases out on a dollar-for-dollar basis as the amount of seller financing exceeds $2 million and 100 percent of the applicable Federal rate on the excess. The $2 million and $4 million threshold amounts are indexed for inflation after 1988. In certain circumstances, the discount rate used in determining the amount of imputed interest in a transaction is limited if the applicable Federal rate exceeds 12 percent.

The Committee bill also provides that the rate used to impute interest in a transaction in which inadequate interest is stated is the same as the test rate (i.e., there would be no higher penalty rate where inadequate interest is stated). In addition, the Federal rates will be determined on a monthly basis, and a rate for a month may be used for sales or exchanges occurring in that month and the next two succeeding months. The imputed interest rules will not apply to assumed loans.

Further, in certain transactions where the amount of seller-financing is not more than $2 million, the Committee bill allows the parties to elect to account for interest in the transaction on the cash method of accounting. The election cannot be made if the seller is a dealer in the property sold or uses the accrual method of accounting.

The amendments by the Committee bill to the imputed interest and original issue discount rules apply to sales and exchanges after June 30, 1985.

With the exception of the limitation on the discount rate where the applicable Federal rate exceeds 12 percent, identical provisions are contained in the House bill.

Below-market loan rules

The Committee bill clarifies the application of the below-market loan rules for certain loans made to "continuing care facilities" pursuant to "continuing care contracts." In general, a continuing care facility is a combination of a retirement community and a facility for the provision of long-term nursing care. The continuing care contract provides a retired individual or couple with residential accommodations, ongoing personal care, and an insurance-type arrangement under which long-term nursing care will be provided when necessary without substantial additional cost to the retirees. In general, where a loan in such an arrangement was made on or prior to the date of enactment, or where the loan is made during or after the calendar year in which the lender reaches age 65 and the amount of the loan does not exceed $90,000, the loan is excepted from the below-market loan rules. Loans made after the date of enactment to continuing care facilities pursuant to continuing care contracts, will be subject to the below-market loan rules to the extent the principal amount of the loan exceeds $90,000 or where the lender does not meet the age requirement.

The Committee bill also modifies the below-market loan rules relating to employer-employee loans the proceeds of which are used by the employee to purchase a principal residence in connection with certain changes in employment. Under the Committee bill, the rate used to determine whether such a loan bears adequate interest is the applicable Federal rate for the date on which a written contract to purchase the principal residence is entered into, rather than at the time the loan is made. This modification is effective for loans made with respect to purchase contracts entered into after June 30, 1985.

ACRS recovery period for real property

The Committee bill extends the ACRS recovery period for real property (other than low-income housing) from 18 years to 19 years. This change generally will be effective for property placed in service after May 8, 1985. However, the longer recovery period will not apply to property placed in service after May 8, 1985, and before January 1, 1987, if the taxpayer entered into a binding contract to purchase or construct the property before May 9, 1985, or construction of the property began before May 9, 1985. The House bill contains an identical provision.

II. PRESENT LAW

A. The Original Issue Discount Rules

Treatment of original issue discount as interest

If the borrower receives less in a lending transaction than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[1] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[2]

Definitions

"Original issue discount" is defined as the excess of a debt instrument's "stated redemption price at maturity" over its "issue price" (provided such excess is not less than a certain *de minimis* amount).

"Issue price" is generally (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,[3] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, the amount determined under section 1274, as discussed below.

"Stated redemption price at maturity" includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period" (i.e., each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months

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[1] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[2] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982 and the 1984 Act greatly expanded the number and types of obligations to which the OID rules apply.

[3] Presently, only stock or securities traded on an established securities market are treated as publicly traded. However, section 103 of the proposed Technical Corrections Act of 1985 (S. 814) would grant the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

prior to the date of maturity). The adjustment to the issue price for each accrual period is determined by multiplying the "adjusted issue price" (i.e., the issue price increased by adjustments prior to the beginning of the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction.[4]

B. Determination of Issue Price in Debt-for-Property Transactions: Section 1274

In general

Section 1274, added by the 1984 Act, performs two roles. First, section 1274 tests the adequacy of stated interest in certain debt instruments issued for nonpublicly traded property and, where stated interest is inadequate, recharacterizes a portion of the principal of the debt instrument as interest. Second, section 1274 prescribes the issue price of the debt instrument. If the issue price so prescribed is less than the debt instrument's stated redemption price at maturity, the application of the OID rules will require the issuer and the holder of the debt instrument to use the accrual method of accounting for any interest. (whether stated or imputed) that is not paid currently. Thus, the impact of section 1274 is to require the lender and borrower to account for interest annually in an amount equal to the greater of the stated interest rate or a rate deemed to be adequate (i.e., the "imputation rate," described below).

Subject to certain exceptions, described below, section 1274 determines the issue price of a debt instrument issued in connection with the sale or exchange of property if (1) neither the instrument nor the property received in exchange for the instrument is publicly traded; (2) some or all of the payments under the instrument are due more than six months after the sale; and (3) the stated redemption price at maturity of the instrument exceeds its stated principal amount (if there is adequate stated interest) or its "imputed principal amount" (if there is inadequate stated interest).

Determination of issue price and amount of OID under section 1274

The issue price of an obligation subject to section 1274 is the stated principal amount of the instrument unless there is inadequate stated interest. In order to determine whether stated interest is adequate, the stated principal amount of the debt instrument

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[4] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender is then deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

is compared with the "testing amount"—the amount determined by discounting all payments due under the instrument at a prescribed "test rate." An instrument contains adequate stated interest if the stated principal amount is less than or equal to the testing amount.

If a debt instrument does not contain adequate stated interest, section 1274 deems the principal amount (and the issue price) of the instrument to be the "imputed principal amount." The imputed principal amount is the amount determined by discounting all payments due under the instrument using a prescribed "imputation rate." which is higher than the test rate.

In effect, where section 1274 applies, if the debt instrument does not bear interest at a rate at least equal to the prescribed test rate, interest will be imputed at a higher rate. Moreover, if such interest is not unconditionally payable at least annually,[5] the OID rules will require periodic inclusion and deduction of the accrued but unpaid interest. The OID rules also apply if an instrument provides for adequate interest payable at least annually, but also provides for fixed additional amounts of interest that are not paid currently. In such a case, the instrument is deemed to contain OID equal to the additional interest. Pursuant to the OID rules, a portion of this OID is reported as income by the lender and deducted by the borrower currently.[6]

"Test rates" and "imputation rates"

Under section 1274, whether there is adequate stated interest in a transaction is determined by reference to an appropriate test rate. The test rate for a debt instrument subject to section 1274 is the rate in effect on the first day there is a binding contract for the sale or exchange of the property. All test and imputation rates are applied using semiannual compounding.

General rule.—For sale or exchange after December 31, 1984, of new property eligible for the investment credit, and for all sales or exchanges after June 30, 1985, the test rate is 110 percent of the "applicable Federal rate," and the imputation rate is 120 percent of the "applicable Federal rate."

Applicable Federal rate.—The applicable Federal rate ("AFR") for a debt instrument is the lower of two published rates, one specified by the 1984 Act and one specified in temporary Treasury regulations. The statutory rate is based on the weighted average of yields over a period of six months for marketable obligations of the United States Government with a comparable maturity. Such rates are redetermined at six-month intervals for three categories of debt instruments: short-term maturity (three years or less), mid-term

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[5] As discussed below, the prescribed test rates are based on semiannual compounding. Accordingly, if interest is payable annually, the amount payable must reflect the compounding of the test rate. If interest is payable at intervals more frequent than semiannual, the nominal rate may be adjusted appropriately. For illustration of the adjustments to the prescribed rate based on the intervals at which interest is paid, *see, e.g.*, Rev. Rul. 85-58, 1985-8 I.R.B. 5.

[6] An exception from the accrual accounting requirement is provided for debt issued in connection with sales of property not eligible for the investment credit and used in the active trade or business of farming. This exception applies only if the sale takes place after December 31, 1984, and prior to July 1, 1985, and the borrowed amount does not exceed $2 million. Interest on such debt is accounted for by both the borrower and the lender on the cash method of accounting.

maturity (more than three years but not in excess of nine years), and long-term maturity (more than nine years).[7]

The rates determined under the temporary Treasury regulations are intended to reflect more accurately the current marketplace.[8] These rates are computed monthly using the same methodology described above, except that the rates reflect the average yields for one-month periods. In any month, the lower of the six-month rate of the monthly rate is the AFR. However, in cases where the monthly rate for either of the two preceding months is lower than the AFR for a particular month, the test rate for that month is the lower of the two such rates.

Special rule for certain transactions before July 1, 1985.—For sales or exchanges after December 31, 1984, and before July 1, 1985, or property other than new property eligible for the investment credit, the test rate for "borrowed amounts" not exceeding $2 million exceeding $2 million is 9 percent. The test rate for borrowed amounts exceeding $2 million is a "blend" of 9 percent on the first $2 million and 110 percent of the AFR on the excess. In applying the $2 million limitation, all sales or exchanges that are part of the same transaction (or a series of related transactions) are treated as one transaction, and all debt instruments arising from the same transaction (or a series of related transactions) are treated as one debt instrument. The imputation rate for transactions during this same period is 10 percent for borrowed amounts up to $2 million and a blend of 10 percent and 120 percent of the AFR for borrowed amounts exceeding $2 million.

Limitation on principal amount of a debt instrument

Notwithstanding the computation of "issue price" discussed above (and, accordingly, the buyer's basis in the property), the principal amount of any debt instrument under section 1274 in a "potentially abusive situation" is equal to the fair market value of the property sold.[9] This limitation applies whether the stated interest is adequate or inadequate under section 1274.

A potentially abusive situation includes any transaction involving a "tax shelter" (as defined in sec. 6661(b)(2)(C)(ii)). It also includes any other situation that, because of (1) recent sales transactions, (2) nonrecourse financing, (3) financing with a term beyond the enonomic life of the property, or (4) other circumstances, is of a type which the Treasury Department by regulation identifies as having a potential for abuse.

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[7] Appropriate adjustments to the rates are to be made for application to debt instruments, the interest on which is wholly or partly exempt from tax (sec. 1288).

[8] The mechanism provided by the temporary regulations is intended to respond to a problem that may exist where interest rates decline after the period in which the Federal rates were determined.

[9] The principal amount of the note is reduced to reflect the fair market value of other consideration involved in the transaction. This provision prevents both overstatement and understatement of the buyer's basis in the property. The purpose of the latter restriction is to prevent the intentional overstatement of OID. A taxpayer might be motivated to overstate the interest element of a sale, for example, if the property involved in the sale were nondepreciable or the seller were not subject to U.S. tax on interest income.

Exceptions

Specific exceptions are provided for certain debt instruments that otherwise would be subject to section 1274. However, these debt instruments may be subject to the rules of section 483. As discussed below, section 483 tests the adequacy of interest in a debt instrument without requiring annual inclusion and deduction of accrued but unpaid interest. Debt instruments that are excepted from section 1274 are as follows:

Personal-use property.—Issuers (but not holders) of debt instruments issued in exchange for property, substantially all of which will not be used by the issuer in a trade or business or held by the issuer for the production or collection of income, are excepted from section 1274. Accordingly, a cash-method issuer of such an obligation may claim interest deductions only for amounts of stated interest actually paid during the taxable year.

Annuities.—Section 1274 does not apply to an annuity to which section 72 applies and the liability for which depends in whole or in substantial part on the life expectancy of any individual. In addition, section 1274 does not apply to any annuity (whether or not dependent upon life expectancy) issued by an insurance company (subject to tax under Subchapter L), provided the annuity is issued (1) in a transaction in which only cash or another annuity contract meeting the requirements of this exception is exchanged for the annuity, (2) upon exercise of an election under a life insurance policy by a beneficiary thereof, or (3) in a transaction involving a qualified pension or employee benefit plan.

Patents.—An exception is provided for payments attributable to a transfer of a patent, provided the transfer is eligible for capital gain treatment under section 1235 and such payments are contingent upon the productivity, use, or disposition of the patent. Thus, the exception does not apply in the case of a deferred lump-sum amount payable for a patent.

Farms.—Section 1274 does not apply to debt instruments received by an individual, estate, or testamentary trust, by a small business corporation (as defined in sec. 1244(c)(3)), or by certain partnerships[10] in exchange for a farm. This exception applies only if the sales price does not exceed $1 million.[11]

Principal residences.—Debt instruments received by an individual as consideration for the sale or exchange of that individual's principal residence (within the meaning of sec. 1034) are not subject to section 1274, regardless of the amount involved in the transaction.

Total payments not exceeding $250,000.—Section 1274 does not apply to any debt instrument given in exchange for property if the sum of (1) the payments due under the instrument (whether designated principal or interest) and under any other debt instrument

[10] That is, those partnerships whose capital is not in excess of the limits specified in sec. 1244(c)(3).

[11] Sales and exchanges that are part of the same transaction or a series of related transactions are treated as one sale or exchange, in order to prevent taxpayers from avoiding the $1 million limitation by dividing what is in substance a single transaction into two or more smaller transactions. The exception for farms as well as the exceptions following are nevertheless subject to sec. 483, as more fully discussed in the text below.

given in the transaction, and (2) the fair market value of any other consideration given in the transaction, does not exceed $250,000.[12]

Land transfers between related persons.—Section 1274 does not apply to an instrument to the extent that section 483 (f), relating to certain sales of land between related parties, applies.

C. Measurement of Principal and Interest in Transactions Not Subject to the OID Rules: Section 483

In general

Section 483 generally applies to nonpublicly traded debt instruments given in exchange for nonpublicly traded property where such debt instruments are not subject to section 1274. Under section 483, an instrument is tested for adequate stated interest in the same manner, and using the same test rates, as under section 1274. Where stated interest is inadequate, section 483 recharacterizes a portion of the principal amount of the instrument as interest which, in general, is equal to the additional amount of OID that section 1274 would inpute.[13]

However, unlike section 1274, section 483 does not require imputed interest (or stated interest) to be accounted for on an accrual basis. Stated interest on a debt instrument subject to section 483 is accounted for under the taxpayers's usual method of accounting. Imputed interest is accounted for by cash-method taxpayers when the payments, portions of which are recharacterized as interest by section 483 are made, or by accrual-method taxpayers when such payments are due. The portion of the imputed interest that is allocated to a payment is that portion of the total imputed interest which, in a manner consistent with the method of computing interest under the OID rules, is properly allocable to such payment.

Exceptions

Excepted transactions.—Section 483 contains the same exceptions for sales of personal-use property, annuities, and patents that apply to section 1274. In addition, section 483 does not apply where the sales price of the property does not exceed $3,000.

Lower test rates.—In the case of a sale after June 30, 1985, of a principal residence where the purchase price does not exceed $250,000 or of farm land where the price does not exceed $1 million (where such sale would qualify for exception from section 1274), the test rate may not exceed 9 percent, and imputation rate may not exceed 10 percent. If the purchase price of a principal residence exceeds $250,000, these limits apply to the portion of the deferred payments that $250,000 bears to the sales price; the rates based on the AFR apply to the remainder. In addition, for sales or exchanges of land between an individual and that individual's brothers, sisters, spouse, ancestors or lineal descendants, the test rate under section 483 may not exceed 6 percent. This preferential rate applies only to the extent that the sales price of the land, and the

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[12] This exception is subject to an aggregation rule similar to that provided under the farm sale exception.

[13] For certain transactions, lower test and imputation rates are provided. These transactions are described in the text below.

sales price of all prior sales of land between the same individuals in a calendar year, does not exceed $500,000.

D. Regulatory Authority Relating to Debt-For-Property Transactions

The Treasury Department has authority to issue regulations dealing with the treatment of transactions involving varying interest rates, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments not specifically dealt with in the statute, and other circumstances. The regulatory authority granted to the Treasury Department contemplates possible modification of the generally applicable rules where appropriate to carry out the purposes of the statute, including the provisions of exceptions for transactions not likely to significantly reduce the tax liability of the purchaser by reason of overstatement of the basis of the acquired property.

Pursuant to its regulatory authority, the Treasury Department has provided the monthly rates in order to address the problems that may arise where the statutorily determined rates are significantly higher than prevailing market interest rates.

E. Assumptions of Debt in Connection With the Sale of Property

Neither section 483 nor section 1274 applies to the following debt obligations assumed in connection with the sale or exchange of property, or to debt obligations which property is taken subject to, provided that the terms and conditions of the obligation are not modified in connection with the sale.

Pre-October 16, 1984 obligations

Loans made on or before October 15, 1984, and assumed after December 31, 1984, in connection with a sale or exchange of property, are not subject to section 483 or section 1274 by reason of such assumption.[14] This exception does not apply, however, if the purchase price of the property exceeds $100 million.

Residences

Loans assumed in connection with a sale of a residence by an individual, estate, or testamentary trust are exempt from sections 483 and 1274 if either (1) at the time of the sale, the property was the seller's (or if applicable, the decedent's) principal residence (within the meaning of sec. 1034) or (2) during the two-year period prior to the sale, no substantial portion of the property was of a character subject to an allowance for depreciation. Thus, an assumption of a loan in connection with the sale of a principal residence, or of a vacation home on which a taxpayer may not claim depreciation (e.g., by reason of sec. 280A), generally is not subject to testing for unstated interest under sections 483 or 1274. This exception does not apply, however, to a sale of property that was at any time held by the seller for sale to customers in the ordinary course of business.

[14] The exceptions relating to assumptions of loans also apply to loans which property may be taken subject to.

Farms

Neither sections 483 or 1274 apply to loans assumed in connection with a sale by a "qualified person" of real property used as a farm (within the meaning of sec. 6420(c)(2)) at all times during the three-year period prior to the sale. The exception also applies to loans assumed in connection with the sale of tangible personal property used by the seller of such a farm in the active conduct of a farming business that is also sold in connection with the sale of such a farm for use by the buyer in the active conduct of a farming business. The term "qualified person" includes an individual, estate, or testamentary trust, or a corporation or partnership having 35 or fewer shareholders or partners immediately prior to the sale or exchange, owning at least a 10-percent interest in the property sold.

Trades or businesses

Loans assumed in connection with a sale by a "qualified person" of a trade or business are exempt from sections 483 and 1274. Trade or business has the same meaning as under section 355, except that the rental of real estate under no circumstances qualifies as an active business for this purpose. For purposes of this exception, the term "qualified person" has the same meaning as in the exception for assumptions in connection with the sale of farm properties except that the sale must constitute a disposition of the seller's entire interest in the trade or business and in all substantially similar trades or businesses.

An exception is also provided for a sale of real property used in an active trade or business (as defined above) by someone who would be a qualified person but for the fact that his entire interest in the trade or business is not being sold. Thus, for example, loans assumed in connection with a casual sale by a sole proprietor of real property used in his business could be exempt from sections 1274 and 483.

The trade or business property exception does not apply to a sale of property qualifying under the farm exception, or to property that is new property eligible for the investment credit in the buyer's hands.

F. Below-Market Loans

Section 7872 of the Code, added by the 1984 Act, generally provides that certain loans bearing interest at a below-market rate, are to be treated as loans bearing interest at the market rate accompanied by a payment or payments from the lender to the borrower which are characterized in accordance with the substance of the particular transaction (e.g., gift, compensation, dividend, etc.). The market rate of interest for purposes of section 7872 is assumed to be 100 percent of the AFR at the time the loan is made in the case of a term loan, or in the case of a demand loan, 100 percent of the AFR in effect over the time that the loan is outstanding.

Section 7872 applies to (1) loans where the foregone (i.e., below-market) interest is in the nature of a gift, (2) loans to an employee from a employer or to an independent contractor or one for whom the independent contractor provides services, (3) loans between a corporation and a shareholder of the corporation, (4) loans of which one of the principal purposes of the interest arrangement is the avoidance of any Federal tax, and (5) to the extent provided in regulations, any below-market loan if the interest arrangement of such loan has a significant effect on any Federal liability of either the lender or borrower. Below-market loans made by individuals pursuant to arrangements providing for the satisfaction of personal needs in retirement may be considered to come within either of the last two categories. The application of section 7872 is limited by certain *de minimis* exceptions and, for certain gift loans, by the net investment income of the borrower.

G. Cost Recovery Deductions For Real Property

In general, domestic real property placed in service after March 15, 1984, and qualifying as recovery property, may be depreciated on an accelerated basis under ACRS over an 18-year period, under tables of recovery percentages prescribed by the Treasury Department. These tables reflect a "mid-month" convention for property placed in service after June 22, 1984. Taxpayers may also elect to depreciate such property on a straight-line basis over 18, 35, or 45 years. The recovery period under ACRS for low-income housing described in sections 1250(a)(1)(B) (i), (ii), (iii) or (iv) is 15 years and no mid-month convention is used.

Under transitional rules provided by the 1984 Act, property placed in service after March 15, 1984, pursuant to binding contracts entered into, or where construction was commenced by or for the taxpayer, prior to March 16, 1984, may be eligible for a 15-year recovery period. Special rules under the 1984 Act are also provided relating to components of real property placed in service prior to March 16, 1984, that are placed in service on or after that date.[15]

[15] Sec. 168(f)(1).

III. REASONS FOR CHANGE

A. The Imputed Interest Rules

In general

The imputed interest rules of the 1984 Act have been perceived as complex in several respects. The changes made by the Committee bill attempt to simplify the imputed interest rules, while retaining the basic purposes of the 1984 legislation.

The imputed interest rate

The Committee believes that taxpayers entering into smaller transactions should not have to keep track of the fluctuating imputed interest rates prescribed by the 1984 Act. Accordingly, the Committee bill provides a single maximum test rate of 9 percent for transactions where the amount of seller financing does not exceed $2 million. In addition, in order not to create unfairness where the size of the transaction is slightly above the $2 million threshold amount, the Committee bill phases out the 9-percent rate on a dollar-for-dollar basis on amounts between $2 million and $4 million.

The definition of the AFR provided by the 1984 Act was intended to be a current measure of minimum borrowing rates for a given range of maturities. The mechanism for determining the AFR under the 1984 Act (and the temporary Treasury regulations), however, lags somewhat behind the market. For example, where interest rates are falling rapidly, it is possible for the appropriate borrowing rates for a particular transaction to be slightly lower than 110 percent of the AFR. Accordingly, the Committee believes that it is appropriate to reduce the imputed interest rate to 100 percent of the AFR.

The Committee believes that an imputed interest rate of 100 percent of the AFR (for transactions not eligible for the lower fixed test rate) is a fair minimum rate and one which will not impose hardships on taxpayers. In recognition that there might be certain isolated circumstances in which a different rate would be more appropriate, the Committee bill grants the Treasury Department authority to issue regulations that would permit taxpayers to demonstrate that a lower rate is more accurate in proper cases.

The Committee is concerned, however, that even with the lower test rate provided by the bill, sales of property may be hindered when interest rates in the financial markets (and hence the Federal rates) increase above interest rates that were typically experienced. Accordingly, the Committee amendment provides that if the AFR exceeds 12 percent, the discount rate used in determining the adequacy of interest in a transaction will be limited in certain cases.

The Committee also believes that it is an unnecessary complication to maintain the dual mechanism for determining the AFR that is currently provided by the 1984 Act and temporary Treasury regulations. The mechanism provided by the regulations has worked adequately to provide a rate which is current, yet because of the three-month period that a taxpayer may use the rate, is stable. Consequently, the Committee bill eliminates the six-month rate.

Finally, the Committee believes that the higher imputation provided by the 1984 Act often acted as a penalty for uninformed taxpayers. Knowledgeable taxpayers will always avoid the higher imputation rate by providing for stated interest at the applicable test rate. Accordingly, the Committee bill eliminates the higher imputation rate.

Method of accounting

The 1984 Act attempted to prevent mismatching of interest income and interest deductions by requiring both the buyer and the seller to account for the interest in the transaction on the accrual method of accounting. Nevertheless, calculating and accounting for accrued but unpaid interest may impose hardship on taxpayers who might have to report taxable income in advance of receiving cash with which to pay the tax. This aspect is inconsistent with the Committee's intention to relieve smaller transactions from complexity. Therefore, the Committee bill permits taxpayers in certain smaller transactions to elect to use the cash receipts and disbursements method of accounting for interest income and expense, provided that both buyer and seller jointly agree to do so.

Assumptions

While the changes that the 1984 Act made in the imputed interest rules were in large part intended to stop abuses that result from the manipulation of principal and interest in a debt instrument arising from a seller-financed sale of property, many taxpayers have argued that the assumption of a debt instrument does not present the same potential for abuse as does a seller-financed debt instrument because where a debt instrument is assumed and its terms are not modified in connection with the transaction, there is no opportunity for the parties to manipulate principal and interest on the loan. Accordingly, under the Committee bill, the imputed interest rules generally will not apply to assumptions of loans.

B. Below-Market Loans

The Committee believes that encouraging individuals to provide in advance for the potential need for increasing levels of personal care, including long-term nursing care, in the advanced stages of retirement may further a valuable social objective. The Committee also believes that it is desirable for individuals to be able to do so in arrangements in which substantial initial payments are refundable, hence providing the individual with greater flexibility than where the payment is not refundable. Accordingly, the Committee bill clarifies the application of the below-market loan rules with respect to certain arrangements under which such potential needs may be provided for. Under the committee bill, certain loans to "continuing care facilities" pursuant to "continuing care contracts" are excepted from the below-Market loan provisions. Loans to continuing care facilities pursuant to continuing care contracts are, however, subject to the below-market loan rules to the extent that specific criteria for the exception are not met.

In light of the changes made by the Committee bill to the computation of the applicable Federal rate, the Committee believes that the appropriate time for determining the adequacy of interest on employer-employee loans where the employee uses the proceeds toward the purchase of a principal residence in connection with certain changes in employment is the time the employee contracts to purchase the principal residence rather than at the time the loan is made. Accordingly, the Committee bill amends the below-market loan rules to so provide.

C. ACRS Recovery Period for Real Property

The Committee believes that, in light of the current budget deficit of the Federal Government, there should be an offset for the revenue loss resulting from the changes the Committee bill makes to the imputed interest rules (much of which results from transactions involving real property.) The Committee also believes that the useful life of most real property exceeds 18 years and that an increase in the cost recovery period for real property would more correctly measure the income from real property. Accordingly, to maintain revenue neutrality, the Committee bill would extend the ACRS recovery period of real property (other than low-income housing) from 18 years to 19 years.

IV. EXPLANATION OF THE BILL

A. The Imputed Interest Rules

1. The imputed interest rate

In general

The Committee bill makes five basic changes to the imputed interest rates. First, the Committee bill reduces the test rate from 110 percent of the AFR to 100 percent of the AFR. Second, the Committee bill provides for lower imputed interest rates for certain smaller transactions. Third, the Committee bill provides lower imputed interest rates for certain transactions where the AFR exceeds 12 percent. Fourth, the Committee bill provides that the imputation rate would be the same as the test rate (i.e., there would be no higher "penalty rate" where inadequate interest is stated). Finally, the Committee bill revises the computation of the AFR from a semiannual rate to a monthly rate.

Lower overall imputed interest rate

Under the Committee bill, the imputed interest rate (i.e., the test rate and the imputation rate) is reduced to 100 percent of the AFR.

Lower imputed interest rates for certain smaller transactions

The Committee bill places a limit on the imputed interest rates in smaller transactions which do not involve new property eligible for the investment tax credit. Under these rules, where the amount of seller financing [16] does not exceed $2 million, the Committee bill provides that the imputed interest rate cannot exceed 9 percent.[17] Where the amount of seller financing exceeds $2 million but is less than $4 million, the imputed interest rate is a "blend" of 9 percent on a specified portion of the seller financing and the 100 percent of the AFR on the remainder.[18] The portion of the seller-financing eligible for the 9 percent rate is equal to $2 million reduced dollar-for-dollar by the amount of seller financing over $2 million. For example, if the amount of seller financing were $2.5 million, the imputed interest rate would be the weighted average of 9 percent on $1.5 million (i.e., $2 million reduced by the excess of $2.5 million over $2 million) and the AFR on the remaining $1 million.[19] Where the amount of seller financing is $4 million or more, the imputed interest rate is equal to 100 percent of the AFR, unless the

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[16] The amount of seller financing is measured by the stated principal amount of the seller-financed debt instrument.

[17] As under present law, all rates will be compounded semiannually.

[18] A special limitation on the AFR used in the blending formula may apply where the AFR exceeds 12 percent. See discussion below.

[19] The weighted average in the example may be computed as follows, assuming an AFR of 11.5 percent: 9 percent times 0.6 (i.e., $1.5 million divided by $2.5 million) plus 11.5 percent times 0.4 (i.e., $1.0 million divided by $2.5 million) equals 10 percent.

special limitation described in the following section applies. The $2 million and $4 million "thresholds" will be indexed for inflation beginning after 1988.

For sales of new property eligible for the investment credit, the imputed interest rate for a seller-financed debt instrument is equal to the AFR regardless of the amount of seller financing, unless the special limitation discussed below applies.

Limitation on discount rate in certain circumstances where AFR exceeds 12 percent

Under the Committee bill, for a three-year period, the imputed interest rate in transactions involving $4 million or more in seller financing is limited in certain circumstances, and the imputed interest rate for transactions involving between $2 million and $4 million is further limited.

If the transaction involves $4 million or more in seller financing and the AFR exceeds 12 percent and one of two tests is met, the imputed interest rate is limited to 12 percent plus one-third of the excess of the applicable Federal rate over 12 percent.

The first test is satisfied if the debt instrument is issued in exchange for property which is depreciable or amortizable in the hands of the buyer and (a) the stated principal amount of the debt instrument is not more than 50 percent of the total sales price of the property, (b) the term of the instrument (including any extension or renewal) is not greater than two-thirds of the "statutory recovery period"[20] of the property, and (c) the instrument requires the unconditional payment at fixed periodic intervals of one year or less of at least 80 percent of the total interest allocable to the period to which the payment relates.

The second test is satisfied if the debt instrument is given in exchange for property that is nondepreciable and nonamortizable in the hands of the purchaser. Except as provided in Treasury regulations, a purchase of a partnership interest or stock representing control[21] of a corporation will not qualify under this test. Such purchases will be treated as purchases of the underlying assets and the debt instruments will be eligible for the limited rate only if they satisfy the conditions of the first test.

The Committee expects that the regulations will permit a transaction to qualify for the limited rate under the second test if the transaction does not result in the purchaser's obtaining a stepped-up basis in all or a portion of the assets of the corporation or partnership. For example, the second test generally should be satisfied and the rate limitation therefore should apply, without regard to whether the first test would be satisfied if the debt instrument were issued for the underlying assets, if the transaction involves a qualified stock purchase under section 338 and no election is made or deemed to have been made under that section. Likewise, the limitation should generally apply if the purchaser will not obtain a stepped-up basis in the underlying assets by virtue of a corporate

[20] For purposes of this provision, the term "statutory recovery period" means the recovery period under section 168 in the case of property with respect to which deductions are allowable under that section, and in the case of other property, the period over which deductions for depreciation or amortization are otherwise allowable.

[21] For this purpose, control has the same meaning as under sec. 304(c).

liquidation under section 331 or, in the case of the acquisition of a partnership interest, by reason of an election under secton 754 or a liquidation of the partnership under section 732 (b).

If a debt instrument is issued in exchange for several properties, the principal amount must be allocated to each of the properties on the basis of their relative fair market values, and the three-part test will be applied separately to each depreciable or amortizable piece of property. If the transaction involves a sale of land and any 15-year, 18-year or 19-year real property (together with a *de minimis* amount of incidental personal property), no allocation must be made, and both the land and the incidental personal property shall be treated as having a statutory recovery period equal to the statutory recovery period for the depreciable real property.

In the case of transaction involving seller financing of more than $2 million but less than $4 million, the bill provides that, subject to the two tests described above, the imputed interest rate is determined by blending 9 percent with the discount rate determined pursuant to the limitation just described.

The limitation applies only to sales or exchanges occurring on or before June 30, 1988.

Elimination of the penalty rate

Under the Committee bill, the imputation rate for a debt instrument that fails to state adequate interest will be the same as the test rate for that instrument. Accordingly, there is only one "imputed interest rate" for a transaction and there is no separate "penalty rate" where a debt instrument does not state adquate interest for any reason.

Determination of the applicable Federal rate

Under the Committee bill, the sole mechanism for determining the AFR will be the one currently prescribed by the temporary Treasury regulations. The alternative mechanism under present law for determining the six-month rate prescribed by the 1984 Act will be eliminated.

Under these revised rules, the AFR will be computed using the same methodology as under present law, except that the rates will be determined on a monthly basis and the rate will reflect the average yields for one-month periods. In addition, the AFR for a particular month may be used as the imputed interest rate for contracts for sales or exchanges entered into in that month and the next two succeeding months.

Regulatory authority

Aggregation rules.—The Committee bill authorizes the Treasury Department to issue regulations specifying the circumstances in which transactions will be treated as "part of the same transaction or related transactions" for the purpose of applying the $2 million and $4 million limitations. These regulations will address transactions involving multiple sellers, multiple buyers, "pass-through" entities, and one transaction structured as a series of small transactions. It is anticipated that the regulations will aggregate transactions in which multiple buyers or multiple sellers are acting in concert. The Committee does not intend, however, that multiple sales by a taxpayer who is a dealer in the property sold, to unrelated buyers in otherwise unrelated transactions (such as typically occurs when a home builder sells homes in unrelated transactions to different home buyers), be aggregated.

Lower rates.—The Committee bill also provides that the Treasury Department is authorized to issue regulations under which taxpayers would be permitted to demonstrate that, in appropriate circumstances, a rate lower than the AFR provided by the statute, but calculated according to the same principles as the AFR, is a more appropriate imputed interest rate for a particular debt instrument. For example, it may be appropriate to use a lower rate where the borrower can demonstrate that it can borrow in the open market at a rate less than the AFR applicable to that maturity of the debt instrument for which the imputed interest rate is to be applied. The regulatory authority granted by this provision is effective as if included in the imputed interest provisions of the 1984 Act.

Coordination with other Code provisions.—The Treasury Department is authorized to issue regulations regarding the relationship of the imputed interest provisions to other Code provisions. The Committee intends to limit the benefit of the lower test rate (provided by section 1274A) to bona fide sales of property between unrelated parties. Accordingly, the regulations may provide that section 1274A would not apply to certain transactions undertaken to avoid other provisions of the Code that require an arm's-length interest rate. For example, where a corporation purchases $2 million of nonpublicly traded debt yielding a rate equal to the AFR and sells that debt obligation to its shareholders for a note paying interest at 9 percent, the Committee understands that the regulations would provide that there would be additional interest income to the corporation. The Committee anticipates that the Treasury Department will exercise the regulatory authority granted by the 1984 Act to provide rules under which contingent payments (e.g., payments based on future sales or rental receipts) may be taken into account in determining whether or not a debt instrument has adequate stated interest in transactions that would not thereby be subject to abuses. In addition, the Committee intends that the Treasury Department's 1984 Act regulatory authority will be exercised with regard to situations where the OID rules are avoided as a result of prearranged or systematic discounting of seller-financed debt instruments.

2. Method of accounting

The "cash-cash" election

The Committee bill provides that, in the case of certain debt instruments that otherwise would be subject to section 1274, interest income and expense arising from such debt instruments may be accounted for on the cash receipts and disbursements method of accounting. To be eligible for such treatment, (1) the stated principal amount of the debt instrument cannot exceed $2 million, (2) the debt instrument must arise from the sale of property by a cash-basis taxpayer who is not a dealer in the type of property sold, and (3) the lender and the borrower must jointly elect such treatment.[22] A debt instrument meeting these requirements is to be known as a "cash-method debt instrument."

Transfers and assumptions of cash-method debt instruments

Special rules are provided relating to the treatment of taxpayers who are the successors to either the issuer or holder of a cash-method debt instrument. Generally, such a successor shall also be required to use the cash receipts and disbursements method of accounting for interest income and expense arising from the cash-method debt instrument. Accordingly, where an accrual-method taxpayer assumes the liability on a cash-method debt instrument, that taxpayer must use the cash-method to account for interest expense arising from the instrument. An exception is provided where a cash-method debt instrument is transferred to a subsequent holder who uses the accrual method of accounting. In this case, the exception requires the subsequent holder to continue to use his normal method of accounting (i.e., to use the accrual method).

Regulatory authority

The Treasury Department is authorized to issue regulations prescribing rules to prevent abuses of the special treatment afforded to cash-method debt instruments. The Committee intends that the delegation of regulatory authority will be exercised only to prevent abuse situations.

One situation that such regulations may address is the timing of deductions for interest on indebtedness incurred or continued to acquire or carry a cash-method debt instrument. Another situation that may be addressed is one where a cash-method debt instrument remains outstanding when the property, the initial sale of which gave rise to the cash-method debt instrument, is resold in a transaction involving a seller-financed debt instrument.

A third situation which the regulations may address relates to the treatment of transfers of cash-method debt instruments. It is anticipated that these regulations will clarify existing law regarding (1) the amount and character of gain realized on disposition of a cash-method debt instrument, (2) the allocation of payments on the debt instrument between income and recovery of basis for a subsequent holder, and (3) the timing of interest deductions for, and the allocation of interest deductions between, the initial issuer and a taxpayer who assumes the issuer's obligations on a cash-method debt instrument.[23]

3. Assumptions

Under the Committee bill, if an existing debt instrument is assumed in connection with the sale or exchange of property (or if the property is acquired subject to an existing debt instrument), section 1274 and section 483 do not apply to such existing debt instrument by reason of such assumption (or acquisition) unless the terms of the existing debt instrument are modified in connection

[22] The Committee intends that, until regulations are issued specifying a different method of election, the parties can make the election by so indicating in their respective tax returns and stating the election clearly in the debt instrument.

[23] *See, e.g., United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); Treas. Reg. sec. 1.61-7; Code secs. 1276 *et seq.*

with the transaction or the nature of the transaction is changed.[24] If only minor modifications are made in the terms of the loan, the Committee does not intend that the imputed interest rules will be applied.

Under temporary Treasury regulations, for installment reporting purposes, a so-called wrap-around debt instrument may be treated like an assumption of the so-called "wrapped" (or underlying debt). However, many taxpayers have taken the contrary position. The Committee believes that a wrap-around debt should be treated consistently for purposes of the installment reporting and imputed interest rules. The Committee does not wish to address the proper treatment of wrap-around debt for installment reporting at this time. Moreover, the Committee wishes to avoid the situation where the seller takes the position that the wrap-around debt does not result in immediate taxation, while the buyer takes the position that the entire amount of the wrap-around debt is exempt from the imputed interest rules. Accordingly, until and unless it is ultimately settled that a wrap-around debt instrument is treated as an assumption for installment reporting purposes, the Committee intends that the exception in the Committee bill relating to assumptions should not apply to wrap-around debt instruments.

B. Below-Market Loan Provisions

1. Loans to continuing care facilities

In general

Under the Committee bill, certain below-market loans to a "continuing care facility," made pursuant to a "continuing care contract" are excepted from the below-market loan provisions of the Code, i.e., no additional interest and offsetting payments will be attributed to such loans. Loans to continuing care facilities pursuant to continuing care contracts are subject to the below-market loan provisions to the extent that the criteria for the exception are not met.

Continuing care contract

A continuing care contract is an arrangement between an individual or a married couple and a continuing care facility with certain specified requirements. Under the first requirement, a retired individual or couple must be entitled to use of the continuing care facility for the remainder of the individual's or both married spouses' lives. Under the second requirement, such use must commence with residence in a separate, independent living unit provided by the continuing care facility.[25] The independent living unit is provided for so long as the individual or either of the married spouses is capable of living independently, and during this period the individual may not require (in order to maintain residence in

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[24] The Committee intends that the nature of the transaction is to be considered changed if, for example, the loan which is to be assumed arose in a transaction that was excepted from section 483, but the subsequent transaction does not qualify for the exception. *See, e.g.*, Treas. Reg. sec. 1.483-1(f)(6)(iv) (Example 4).

[25] It is contemplated that such units would have their own kitchen, bath, and living area, and would be of a nature that provides the same degree of convenience and privacy as a private residence.

such independent living unit) care other than the providing of meals and other personal care services, as described below.

Under the third requirement, during the period in which the individuals reside in the independent living units, the continuing care facility must be obliged to provide such individuals with various "personal care" services. These are services that are designed to prolong an elderly person's ability to maintain an independent residence. Examples are services relating to maintenance of the residential unit, the preparation of meals, (either on a common basis or within the separate living unit), and daily aid and supervision relating to routine medical needs.

Under the fourth requirement, the continuing care facility must also undertake to provide long-term nursing care for those individuals who are no longer capable of living independently, even with the aid of personal care services. Under the fifth requirement, the continuing care contract must require the continuing care facility to provide the personal care and long-term nursing services without substantial additional cost to the individual, i.e., there must be a significant insurance-like element for the individual.

The Committee intends that the personal care and custodial care services are to be substantial, so that they in fact prolong the ability of an individual to maintain an independent residence, except in the case of sudden, totally disabling medical cause. For example, the mere provision of maid services and a registered nurse on the premises of a retirement community would not be sufficient.

Continuing care facility

A continuing care facility is one or more facilities which are designed to provide services under continuing care contracts and substantially all of the residents of which have entered into continuing care contracts. The term "substantially all" is intended to permit isolated situations where an individual may enter the continuing care facility in immediate need of long-term nursing care, particularly if in conjunction with a spouse who simultaneously enters a separate independent living unit in the continuing care facility, or where a newly opened facility may accept several individuals directly into the long-term nursing facility (under normal nursing care arrangements, i.e., not pursuant to continuing care contracts) in order to fill excess capacity.

In addition, substantially all of the facilities used to provide the services that must be provided under a continuing care contract must be in facilities that are either owned or operated by the continuing care facility.

The Committee believes that the exception from the below-market loan rules should be limited to facilities that provide personal care services designed to prolong the ability of retired persons to live independently, as well as an insurance-like arrangement providing for the possible need for long-term nursing care. Accordingly, the exception from the below-market loan rules does not apply to below-market loans to facilities where an individual would generally receive long-term nursing care immediately upon entering the facility without any period of living independently, i.e., facilities of a type traditionally considered to be nursing homes.

Limitations

The exception is available for a loan only as of the calendar year in which the lender has attained age 65. A loan from either or both members of a married couple where only one spouse has attained age 65, will be treated as qualifying for the exception where both of the spouses are to reside in the continuing care facility. Loans made by an individual prior to reaching age 65 which do not qualify initially may nevertheless qualify as of the calendar year in which the individual reaches age 65. The Committee believes that the benefit of this exception should not be afforded to the provision of luxurious accommodations. Accordingly, the exception applies only to the extent that the principal amount of a loan, when added to the aggregate outstanding amount of all other previous loans between the lender (or if the lender is married, the lender and the lender's spouse), to any continuing care facility, does not exceed $90,000. This amount is indexed for inflation.

Transactions not treated as loans

The Committee understands that the below-market loan provisions of the Code prescribe the treatment only of transactions that are loans for Federal income tax purposes, and that such provisions do not define and did not alter prior law relating to what transactions are or are not to be treated as loans. The Committee understands that entrants into a life care facility generally expect to reside at the facility for a considerable length of time. The Committee also understands that a payment to a continuing care facility pursuant to a continuing care contract frequently is wholly or partially refundable for a relatively brief period (e.g., six months) essentially for consumer protection purposes pursuant to State law or regulations. The Committee also understands that payments to a continuing care facility are often refundable on a declining prorata basis over a somewhat longer period (ofter up to eight years). The Committee understands that such payments ordinarily would be treated as the advance payment of fees and not as loans under present law.

2. Employee relocation loans

The Committee bill modifies the below-market loan rules with respect to so-called "employee relocation loans." An employee relocation loan is a loan from an employer to an employee, the proceeds of which are used by the employee toward the purchase of a principal residence in connection with commencement of work by the employee at a new principal place of work. The purchase of the principal residence must occur in a situation where any moving expenses incurred by the employee would be deductible under section 217 of the Code.

In the case of such employee relocation loans, the rate used for determining whether the loan is a below-market loan to which additional interest will be imputed, is the AFR for the month in which the employee enters into a written contract for the purchase of the principal residence rather than the month in which the loan is made.

C. Accelerated Cost Recovery System

Under the Committee bill, the minimum recovery period for domestic real property qualifying as recovery property generally is increased from 18 years to 19 years. However, this change in the recovery period does not affect the ACRS provisions relating to low-income housing (which remains at 15 years).

D. Effective Dates

Imputed interest rules

The provisions of the Committee bill relating to the amendment of the imputed interest rules are effective for sales or exchanges occurring after June 30, 1985. However, the provision limiting the imputed interest rate where the AFR exceeds 12 percent does not apply to any sale or exchange after June 30, 1988. The Committee understands that where a sale or exchange takes place after June 30, 1985, pursuant to a binding contract entered into on or before that date, the imputed interest rates for such a transaction are to be determined pursuant to the provisions of the Committee bill using the applicable Federal rates in effect on the date the binding contract was entered into.

The regulatory authority under which the Treasury Department may permit a taxpayer to use a lower imputed interest rate is effective as if included in the imputed interest provisions of the 1984 Act.

Below-market loans

The provisions of the Committee bill relating to below-market loans to continuing care facilities pursuant to continuing care contracts are generally effective with respect to such loans that are made after the date of enactment. All such loans made on or before the date of enactment are excepted from the below-market loan rules.

The provisions of the Committee bill relating to employee relocation loans are effective for loans made pursuant to purchase contracts entered into after June 30, 1985.

ACRS recovery period for real property

The provision of the Committee bill relating to the ACRS recovery period for real property is generally effective for property placed in service after May 8, 1985. Transitional rules similar to those under the 1984 Act are provided for property that is placed in service after May 8, 1985, and before January 1, 1987, where there was a binding contract to construct or acquire the property, or where construction was begun by or for the taxpayer before May 9, 1985. Special rules apply to components placed in service after May 8, 1985.[26]

In addition, a conforming amendment relating to the eligibility of lessee-incurred costs for the rehabilitation tax credit (secs. 46 and 48(g)) is effective for leases executed prior to May 22, 1985, if the lessee signed the lease before May 17, 1985.

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[26] Sec. 168(f)(1).

V. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

A. Budget Effects

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the effect on the budget of this bill, H.R. 2475, as reported. The following is a summary of the estimated revenue effect of the bill as reported.

Summary of Revenue Effect of the Bill, Fiscal Years 1985-90

[In millions of dollars]

Provision	1985	1986	1987	1988	1989	1990	1985-90
Imputed interest changes	−5	−58	−153	−172	−205	−235	−828
Continuing care facilities	0	−2	−5	−8	−12	−17	−44
ACRS changes	+5	+30	+91	+166	+255	+344	+891
Net revenue effect	0	−30	−67	−14	+38	+92	+19

The Treasury Department agrees with these methodologies. The Treasury Department estimates would reflect the economic projections of the Administration rather than those of the Congressional Budget Office.

Estimating Methodology

The following is a discussion of the estimating methodology involved in making the Committee revenue estimates for the imputed interest and continuing care facility provisions of the bill.

Imputed interest changes

Table 1.—Revenue Estimate for Imputed Interest Provisions, Fiscal Years 1985-90

[In millions of dollars]

Subject	1985	1986	1987	1988	1989	1990	1985-90
General							
Total property cost of which a portion is seller financed	32,800	36,100	39,700	43,600	48,000	52,800	253,000

Table 1.—Revenue Estimate for Imputed Interest Provisions, Fiscal Years 1985-90—Continued

[In millions of dollars]

Subject	1985	1986	1987	1988	1989	1990	1985-90
Amount of seller financing at below market rate	9,800	10,800	11,900	13,100	14,400	15,900	75,900
Weighted interest rates projections for average federal rate (percent)	11.07	10.57	10.20	10.20	10.20	10.20	
Components of the estimate							
Gain from increased capital gains collections from seller	+2	+10	+19	+31	+44	+60	+166
Loss from increased depreciation deductions by buyer	−3	−53	−152	−180	−223	−267	−878
Loss from increased investment tax credit claimed by buyer	−2	−5	−8	−8	−8	−7	+38
Other modifications, and adjustments (including accounting changes)	−2	−10	−12	−15	−18	−21	−78
Total, imputed interest provision	−5	−58	−153	−172	−205	−235	−828

Description of estimating methodology

Lines one through three of the above table set forth the basic data used to estimate the amount of seller-financed property that would be affected by the bill. Line number one, $32.8 billion in 1985, is an estimate of the total acquisition price of property for which some portion is seller-financed. The estimate assumes that the amount of seller-financing in a transaction varies from one transaction to another. Line number two, $9.8 billion in 1985, is an estimate of the amount of seller-financing with below-market interest rates. The volume of these two items is assumed to increase at ten percent annually.

Line number three is an estimate of the interest rates expected over the period 1985 to 1990. These estimated interest rates are consistent with those used by the Congressional Budget Office (CBO).

Lines numbers four, five, and six are estimates of the various components of the revenue effect expected from enactment of the bill. Line number four is an estimate of the revenue gain from the increase in the capital gain taxes of the seller attributable to the increased sales price resulting from the use of the lower imputed interest rates provided by the bill. Line number five is an estimate of the decreased income taxes of the purchaser attributable to the higher depreciation deductions resulting from the same increase sales prices. This estimate assumes that approximately 85 percent of the dollar volume of transactions with below-market rate seller-financing utilized the straight-line method of depreciation. Line number six is an estimate of the decreased taxes of buyers attributable to increased investment credit resulting from the same increased sales prices. This estimate assumes that a relatively small amount of seller-financed property is eligible for the investment credit. The estimates in lines four, five, and six are generated from a matrix of the investments placed in service during a particular year and the cumulative effect of the investments placed in service during prior years that are affected by the bill. These estimates assume that the overall average rate of interest charged in seller-financed transactions is somewhat above the minimum rate provided by the bill.

Other estimates

In addition to the estimates of the revenue effect of the Committee bill, the Committee wished to provide the Senate with the following additional estimates which it might consider relevant in the consideration of the bill.

[In millions of dollars]

	1985	1986	1987	1988	1989	1990	1985–90
Other estimates							
Eliminate phase-out of preferential treatment for transactions above $2 million	−2	−7	−20	−22	−26	−30	−107
Include certain wraparound mortgages for treatment like assumptions	−2	−12	−31	−34	−42	−48	−168

Elimination of the phase-out for transactions, the seller-financed portion of which is in excess of two million, is the first estimate shown above. It was estimated that approximately 52% of the dollar volume of below market seller-financed amounts were below the two million dollar threshold and would not be affected by this amendment. Approximately 35% of the dollar volume was estimated to be above four million dollars in seller-financing and the average federal rate would apply to the entire transaction amount.

The revenue effect of the proposed exception of wraparound debt [27] from the imputed interest rules is dependent upon the volume of debt that is subject to wraparound transactions and the maturity and interest rates on the underlying, wrapped debt. The estimates of these amounts were derived from data on the amount of outstanding indebtedness, estimating the maturity of this indebtedness, and then estimating the interest rates on that indebtedness based upon its estimated maturities.

The revenue effect per dollar of indebtedness in the case of the exception of wrapped indebtedness from the imputed interest rules is estimated to be larger than the effect from other changes in the

[27] In a transaction involving wraparound debt, a seller leaves the original purchase debt on the property outstanding and takes increased purchase debt from the buyer.

bill. This larger revenue effect arises since there are often large differences between the interest rate of the wrapped indebtedness and the imputed interest rates provided by the bill. These large differences arise from the relatively large increases in interest rates in recent years.

The estimate of the volume of transactions involving wraparound debt is based upon the amount of tax and nontax benefits derived from the use of wraparound debt and relatively large pool of indebtedness currently outstanding with interest rates significantly below current and project interest rates. For nontax reasons, wraparound debt is often used to avoid a due-on-sale clause in the seller's note to the original lender or to avoid prepayment penalties.

The tax benefit derived from the exemption of wrapped debt from the imputed interest rules is the alleged ability to defer gain on the sale of the property in conjunction with the testing of the adequacy of the interest rate on debt taken back by the seller on the basis of a lower test rate (i.e., a rate equal to the blend of the rate on the underlying debt and the applicable Federal rate).

Under the installment reporting method of accounting (whereby a seller reports gain in proportion to principal payments received from the buyer), the amount of an assumed obligation is treated as a payment to the seller. However, in the case of a wraparound debt, many taxpayers are taking the position that they need not report any gain until the principal on the wraparound debt is paid. Avoiding treatment of liabilities in excess of basis as payment in the year of the sale for purposes of the installment sales provision is an important tax-planning objective for many taxpayers, especially investors in so-called "burned out" tax shelters who have claimed accelerated depreciation on appreciated highly-leveraged properties.

If wrapped debt is not excepted from the imputed interest rules, the entire amount of the buyer's wraparound note is tested to determine whether it states adequate interest. However, if wraparound debt is treated like an assumption for imputed interested purposes, only the amount of the note attributable to the buyer's equity (i.e., the amount of the note less the principal amount of the wrapped note) would be tested to determine whether it states adequate interest. In other words, the test rate would be a blend of the rate on the underlying note and the normal imputed interest rate applicable to that transactions (i.e., 9 percent, 100 percent of the AFR, or a blend of those two rates, depending upon the size of the transaction).

If wrapped debt is not excepted from the imputed interest rules, the parties would have a choice of structuring the transaction in two different ways that would have different, and offsetting, tax consequences. If the transaction is structured as an assumption, only the amount of the debt equal to the seller's equity would be tested to determine whether it bears adequate interest, but the seller would have immediate recognition of gain on the assumed debt. On the other hand, if the transaction is structured as a wraparound, the entire amount of the debt would be tested to determine whether it bears adequate interest, but the seller allegedly could defer recognition of gain until there are principal payments on the primary note. In other words, the parties could not obtain both the benefits of deferral on the gain and the lower testing rate. In such a case, some transactions may be structured as assumptions, and others as wraparound debt, depending upon the amount of gain to be recognized and the interest rate and maturity of the underlying debt. Nonetheless, whichever way the transactions are structured, there would be an offsetting revenue gain from the inability to achieve both deferral and a lower test rate.

On the other hand, if wrapped debt is excepted from the imputed interest rules, it is possible that the parties could achieve both deferral and a lower test rate (if the parties are successful in their allegation that a wraparound debt does not result in immediate recognition to the seller of the underlying debt). In any event, even if the parties are not ultimately successful in their allegation that the deferral is allowed in the case of wraparound debt, the parties have nothing to lose by initially structuring the transaction as a wraparound debt. As a consequence, there is every likelihood that the dollar volume of transactions that are structured as wraparound debt would be substantial. This is especially true in larger transactions where the value of the deferral is larger, the likelihood is greater that there is more sophisticated tax advice provided, and the ability to litigate the right to defer gain attributable to the wrapped debt is greater.

The average debt outstanding for calendar year 1984 was $406.1 billion for commercial mortgages, $110.8 billion for farm mortgages, and $1,514.6 billion for residential mortgages.[28] The only summary data on maturities by interest rate available for the estimate on existing mortgages were the result of an unpublished project by the Federal Home Loan Bank Board staff. In the study, existing mortgage portfolios for savings and loan associations were broken down into maturity classes by interest rates. The results of this study were then adjusted to account for the generally shorter terms of commercial mortgages and then applied to determine the estimated maturities of the outstanding indebtedness. Interest rates were then associated with these various maturities based upon the market rates of interest at those times.

The estimate assumes that sales in the amount of $45 billion involving some wrapped indebtedness would occur during the period 1985 to 1990. The amount of wrapped indebtedness in these transactions was estimated at $13.3 billion. The estimated revenue effect was then determined by applying the matrix methodology, referred to above, to this estimated volume of wrapped indebtedness for a particular year and the cumulative effect of wrapped indebtedness occurring in prior years.

The estimate assumes that the ability to defer recognition of gain on the wrapped indebtedness is not determined until after the period ending in 1990.

[28] Source: Federal Reserve Bulletin, Board of Governors of the Federal Reserve System, p. A39.

Continuing care facilities

Table 2.—Revenue Estimate of Interest-Free Loans for Lifecare Facilities, Fiscal Years 1985–90

	1985	1986	1987	1988	1989	1990
A. All lifecare facilities:						
Number of facilities	379	398	418	439	461	484
Average number of tenants	265	271	276	281	287	293
Total number of tenants (thousands)	101	108	115	124	132	142
B. Lifecare facilities that offer refundable fees:						
Number of loans:						
New loans, yearly	961	2,027	2,369	2,748	3,170	3,637
Loans outstanding, daily average	240	1,951	3,954	6,117	8,464	11,021
Amount of loans ($ millions):						
New loans, yearly	50	109	132	159	190	225
Loans outstanding, daily average	13	103	213	338	478	638
Imputed taxable income ($ million)	1	11	22	35	49	65
C. Revenue loss ($ million):						
Calendar year	1	3	7	10	15	20
Fiscal year	0	2	5	8	12	17
D. Per tenant characteristics ($):						
Average amount of imputed interest	5,679	5,667	5,668	5,722	5,822	5,942
Average tax benefit	1,704	1,700	1,700	1,717	1,747	1,782

Description of estimating methodology

The number of all continuing care facilities and the average number of tenants per facility were based on the results of a survey, published by the Pension Research Council.[29] That survey identified 274 facilities in 1981 that met a relatively restrictive definition of a continuing care facility; an additional 120 facilities were identified that met an altenative, less restrictive definition. The estimate uses as a starting point the lower bound of 274 facilities. This number was increased for the purpose of the revenue estimate by 10 percent to account for probable undercounting of the survey. It was then increased by between 5 and 6 percent per year

[29] *Continuing Care Retirement Communities: An Empirical, Financial, and Legal Analysis by Howard E. Winklevoss and Alwyn V. Powell.* (Homewood, Illinois: Richard D. Irwin, Inc., 1984), pages 21, 47.

in accordance with the long-term growth rate of continuing care facilities from 1970 to 1980. The average number of tenants per facility, reported as 245 in 1981, was likewise increased at its long-term growth rate of about 2 percent per year. This results in the total number of tenants in all continuing care facilities growing from about 101,000 in 1985 to 142,000 in 1990.

Based on information provided by industry representatives, it was assumed that 10 percent of all continuing care facilities offered refundable fees to tenants in 1985. This was assumed to grow by 1 percent per year as a result of the tax advantages of the type of financing provided in the bill, so that by 1990 about 15 percent of continuing care facilities would offer refundable fees. This implies that in 1985 there would be one new facility offering refundable fees and that by 1990 there would be four new facilities a year offering refundable fees. It also implies that existing facilities would increase their reliance on refundable fees with respect to new tenants entering during this period. It was also assumed, based on standard mortality tables and the probability of tenant withdrawal, that outstanding loans made by tenants would expire at the rate of 10 percent per year.

Generally, the number of loans outstanding was based on the assumption that the loans would be made ratably through each year. Thus, one-half of all loans made on average in any year were counted as outstanding for that year. For 1985, however, a further adjustment was made to account for the probability that the only loans whose tax treatment would be changed by the provisions of the bill would be those made after June, 1985. Therefore, as illustrated in the above table, the number of outstanding loans made by tenants would increase from an average of 240 in 1985 to 11,006 by 1990.

The dollar volume of loans outstanding was based upon a reported average size of $60,000 in 1985, and was increased by the expected change in the Implicit Price Deflator for the Gross National Product as projected by the Congressional Budget Office (CBO). This figure was reduced by approximately 15 percent to account for the portion of income that would be deductible as a medical expense above 5 percent of AGI and to account for the proportion of loans made that were above the $90,000 cap.

The imputed taxable income was based on a long-term interest rate assumption consistent with CBO's Budget assumptions: 11.1 percent in 1985, 10.6 percent in 1986, and 10.2 percent from 1987 to 1990. The revenue loss amounts were based on an assumed 30 percent average marginal tax rate of the tenant. Finally, a fiscal year adjustment was made to reflect the lag in receipts relative to liability.

B. Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate the following statement is made about the vote of the Committee on the motion to report the bill. H.R. 2475, as amended, was ordered favorably reported by a recorded vote of 19–0.

VI. REGULATORY IMPACT OF THE BILL AND OTHER MATTERS TO BE DISCUSSED UNDER SENATE RULES

A. Regulatory Impact

Pursuant to paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of H.R. 2475 as reported.

Numbers of individuals and businesses who would be regulated

The bill does not involve new or expanded regulation of individuals or businesses.

Economic impact of regulation on individuals, consumers and businesses

The bill provides permanent rules relating to imputed interest on seller-financed real property transactions, provides an exception from the below-market loan rules for certain loans made to continuing care facilities pursuant to continuing care contracts, and extends from 18 to 19 years the ACRS recovery period for real property other than for low-incoming housing (which remains at 15 years).

Impact on personal privacy

The bill generally does not relate to the personal privacy of individuals.

Determination of the amount of paperwork

The provisions of the bill relating to imputed interest will simplify the computation of imputed interest on seller-financed real property, and will make the calculation more certain by providing permanent rules. The other provisions of the bill (below-market loans for certain continuing care facilities and ACRS depreciation period for real property) should have little, if any, impact on taxpayer and IRS paperwork.

B. Other Matters

New Budget authority

In compliance with section 308(a)(1) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the Committee states that the changes made to existing law by this bill involve no new budget authority.

Tax expenditures

In compliance with section 308(a)(2) of the Budget Act, and after consultations with the Director of the Congressional Budget Office, the following Committee makes the following statement concerning tax expenditures.

The bill involves increased tax expenditures (relating to the imputed interest and below-market loan rule changes) for fiscal years 1985–1990, as follows: $5 million for 1985, $60 million for 1987, $180 million for 1988, $217 million for 1989, and $252 million for 1990. Also, the bill involves decreased tax expenditures (relating to ACRS cost recovery for real property) for fiscal years 1985–1990, as follows: $5 million for 1985, $30 million for 1986, $91 for 1987, $166 million for 1988, $255 million for 1989, and $344 million for 1990. Overall, for the fiscal years 1985-1990, the bill will involve a net reduction in tax expenditures of $19 million.

Consultation with Congressional Budget Office on budget estimates

In accordance with section 403 of the Budget Act, the Committee advises that the Director of the Congressional Budget Office has examined the Committee's budget estimates (as indicated in part IV of this report) and submitted the following statement:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC. June 12, 1985.

Hon. BOB PACKWOOD,
Chairman, Committee on Finance,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has examined the imputed interest bill, H.R. 2475, as ordered reported by the Committee on Finance, on June 6, 1985, which would replace stopgap legislation concerning income tax treatment of seller-financed real estate sales due to expire July 1, 1985. The bill would maintain more lenient treatment of seller-financed loan amounts below $2 million, while phasing in higher imputed interest rates for larger transactions. The rates would be capped at 100 percent of the applicable federal rate (AFR) for principal loan amounts above $2 million. For some transactions, this cap would be phased in over a three-year period by means of a "governor" clause in the bill, which states that if the AFR exceeds 12 percent the imputed interest rate would be 12 percent plus one-third of the difference between 12 percent and the AFR. In addition, interest would not be imputed on the first $90,000 of a refundable entry fee paid to a continuing care facility by a taxpayer aged 65 or older.

The bill would lengthen from 18 to 19 years the depreciation period for structures to offset the costs of applying lower imputed rates.

We have reviewed and concur with the estimates of the revenue effects of the bill prepared by the Joint Committee on Taxation, shown in the enclosed table.

If you have any questions, please feel free to call.

With best wishes,

Sincerely,

RUDOLPH G. PENNER, *Director.*

Estimates of the Revenue Effects of H.R. 2475

[In fiscal years, millions of dollars]

	1985	1986	1987	1988	1989	1990
Imputed interest provisions	−5	−58	−153	−172	−205	−235
Exemption for payment by taxpayers to continuing care facilities	0	−2	−5	−8	−12	−17
Lengthen depreciation period for structures	5	30	91	166	255	344
Total, revenue effect	0	−30	−67	−14	+38	+92

VII. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the Committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the provisions of H.R. 2475) as reported by the Committee.

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