

Part III. Administrative, Procedural, and Miscellaneous

Debt Instruments Subject to Both § 475 and the Principal-Reduction Method of Accounting

Notice 96-23

The Internal Revenue Service is concerned that the principal-reduction method of accounting for *de minimis* original issue discount (OID) on loans originated by the taxpayer, *see* Rev. Proc. 94-29, 1994-1 C.B. 616, may be used to claim inappropriate tax treatment under the mark-to-market rules of § 475 of the Internal Revenue Code. Accordingly, the Internal Revenue Service requests comments regarding the proper accounting for loans that are subject to both the principal-reduction method of accounting and the mark-to-market rules.

BACKGROUND

A loan is originated with a *de minimis* amount of OID if the loan's stated redemption price at maturity exceeds the issue price of the loan by less than a certain amount (for example, 0.25 percent of a loan's stated redemption price at maturity multiplied by the number of complete years from its issue date to its maturity date). Section 1273(a)(3) and § 1.1273-1(d) of the Income Tax Regulations.

If a loan is originated with a *de minimis* amount of OID, the lender generally includes the *de minimis* OID (other than any *de minimis* OID treated as qualified stated interest) in income as principal payments are made. § 1.1273-1(d)(5). As a matter of taxpayer convenience, Rev. Proc. 94-29 authorizes the use of an aggregate method of accounting (the principal-reduction method) for *de minimis* OID on certain loans originated by a taxpayer. In general, under the principal-reduction method, the portion of the aggregate *de minimis* OID that is taken into account in a taxable year is determined on a monthly basis. The portion is the ratio of the stated principal that is recovered during each month to the sum of the stated principal that is outstanding at the start of the month plus the stated principal on loans originated during the month. Principal is treated as recovered when principal payments are made, when

loans are written off in whole or in part, and when loans are sold or exchanged.

A taxpayer's unadjusted basis in a loan originated with a *de minimis* amount of OID generally is the issue price of the loan. If the loan is accounted for under the principal-reduction method, however, the taxpayer's unadjusted basis in the loan is deemed to be the loan's stated principal amount, which is greater than the loan's issue price. This basis increase assures that all of the gain represented by the *de minimis* OID is recognized solely under the principal-reduction method. *See* section 5.01 of Rev. Proc. 94-29.

Section 475 requires a dealer in securities to use the mark-to-market method of accounting for certain securities, including certain loans. Under this method, a security that is inventory in the hands of a dealer is included in inventory at its fair market value. Any other security subject to § 475 is treated as sold at its fair market value on the last business day of the taxable year, with any resulting gain or loss taken into account by the dealer in the taxable year of the deemed sale.

The Service is considering the proper application of the mark-to-market rules to a loan that is being accounted for under the principal-reduction method. As a result of its consideration to date, the Service has concluded that a taxpayer may not take the basis increase provided under Rev. Proc. 94-29 into account for mark-to-market purposes and, at the same time, treat the principal on the marked loan as outstanding at the end of a monthly computation period (and thus not recovered) for purposes of Rev. Proc. 94-29. This approach would distort the taxpayer's income by allowing the taxpayer to create an artificial loss under § 475 or to avoid recognition under § 475 of all or a portion of the appreciation on the loan. In either case, this distortion is attributable solely to the basis increase provided under section 5.01 of Rev. Proc. 94-29.

The Service is considering a number of alternatives for reconciling mark-to-market accounting and the principal-reduction method. Under one alternative, the entire principal on a loan that is subject to § 475 would be treated as

recovered for purposes of Rev. Proc. 94-29 on the first date on which the loan is required to be marked to market, and the loan would not thereafter be treated as outstanding for purposes of the principal-reduction computation under Rev. Proc. 94-29. Under another alternative, the gain or loss from marking a loan to market under § 475 would be determined without regard to the basis increase provided under section 5.01 of Rev. Proc. 94-29.

REQUEST FOR COMMENTS

The Service requests comments on the most appropriate method of accounting for loans that are subject to both § 475 and the principal-reduction method of accounting, including whether an aggregate method of marking loans to market in this circumstance is feasible and desirable.

Written comments should be sent in duplicate no later than July 15, 1996 to: CC:DOM:FI&P, Room 4300, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. The Service will make these comments available for public inspection.

CONTACT PERSON

This notice was drafted in the Office of Assistant Chief Counsel (Financial Institutions & Products). For further information regarding this notice, contact Albert J. Kiss at (202) 622-3940 (not a toll-free call).