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section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see § 1.446-1(e)(3) in effect prior to December 31, 1997 (§ 1.446-1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

[T.D. 6500, 25 FR 11708, Nov. 26, 1960, as amended by T.D. 7073, 35 FR 17710, Nov. 18, 1970; T.D. 7285, 38 FR 26184, Sept. 19, 1973; T.D. 8067, 51 FR 378, Jan. 6, 1986; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8408, 57 FR 12419, Apr. 10, 1992; T.D. 8482, 58 FR 42233, Aug. 9, 1993; T.D. 8608, 60 FR 40078, Aug. 7, 1995; T.D. 8719, 62 FR 26741, May 15, 1997; T.D. 8742, 62 FR 68169, Dec. 31, 1997; T.D. 8929, 66 FR 2223, Jan. 11, 2001]

§ 1.446-2 Method of accounting for interest.

(a) *Applicability*—(1) *In general.* This section provides rules for determining the amount of interest that accrues during an accrual period (other than interest described in paragraph (a)(2) of this section) and for determining the portion of a payment that consists of accrued interest. For purposes of this section, interest includes original issue discount and amounts treated as interest (whether stated or unstated) in any lending or deferred payment transaction. Accrued interest determined under this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). Application of an exception described in paragraph (a)(2) of this section to one party to a transaction does not affect the application of this section to any other party to the transaction.

(2) *Exceptions*—(i) *Interest included or deducted under certain other provisions.* This section does not apply to interest that is taken into account under—

(A) Sections 1272(a), 1275, and 163(e) (income and deductions relating to original issue discount);

(B) Section 467(a)(2) (certain payments for the use of property or services);

(C) Sections 1276 through 1278 (market discount);

(D) Sections 1281 through 1283 (discount on certain short-term obligations);

(E) Section 7872(a) (certain loans with below-market interest rates); or

(F) Section 1.1272-3 (an election by a holder to treat all interest on a debt instrument as original issue discount).

(ii) *De minimis original issue discount.* This section does not apply to de minimis original issue discount (other than de minimis original issue discount treated as qualified stated interest) as determined under § 1.1273-1(d). See § 1.163-7 for the treatment of de minimis original issue discount by the issuer and §§ 1.1273-1(d) and 1.1272-3 for the treatment of de minimis original issue discount by the holder.

(b) *Accrual of qualified stated interest.* Qualified stated interest (as defined in § 1.1273-1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods).

(c) *Accrual of interest other than qualified stated interest.* Subject to the modifications in paragraph (d) of this section, the amount of interest (other than qualified stated interest) that accrues for any accrual period is determined under rules similar to those in the regulations under sections 1272 and 1275 for the accrual of original issue discount. The preceding sentence applies regardless of any contrary formula agreed to by the parties.

(d) *Modifications*—(1) *Issue price.* The issue price of the loan or contract is equal to—

(i) In the case of a contract for the sale or exchange of property to which section 483 applies, the amount described in § 1.483-2(a)(1)(i) or (ii), whichever is applicable;

(ii) In the case of a contract for the sale or exchange of property to which section 483 does not apply, the stated principal amount; or

(iii) In any other case, the amount loaned.

(2) *Principal payments that are not deferred payments.* In the case of a contract to which section 483 applies, principal payments that are not deferred payments are ignored for purposes of determining yield and adjusted issue price.

(e) *Allocation of interest to payments—*
 (1) *In general.* Except as provided in paragraphs (e)(2), (e)(3), and (e)(4) of this section, each payment under a loan (other than payments of additional interest or similar charges provided with respect to amounts that are not paid when due) is treated as a payment of interest to the extent of the accrued and unpaid interest determined under paragraphs (b) and (c) of this section as of the date the payment becomes due.

(2) *Special rule for points deductible under section 461(g)(2).* If a payment of points is deductible by the borrower under section 461(g)(2), the payment is treated by the borrower as a payment of interest.

(3) *Allocation respected in certain small transactions.* [Reserved]

(4) *Pro rata prepayments.* Accrued but unpaid interest is allocated to a pro rata prepayment under rules similar to those for allocating accrued but unpaid original issue discount to a pro rata prepayment under §1.1275-2(f). For purposes of the preceding sentence, a pro rata prepayment is a payment that is made prior to maturity that—

(i) Is not made pursuant to the contract's payment schedule; and

(ii) Results in a substantially pro rata reduction of each payment remaining to be paid on the contract.

(f) *Aggregation rule.* For purposes of this section, all contracts calling for deferred payments arising from the same transaction (or a series of related transactions) are treated as a single contract. This rule, however, generally only applies to contracts involving a single borrower and a single lender.

(g) *Debt instruments denominated in a currency other than the U.S. dollar.* This section applies to a debt instrument that provides for all payments denominated in, or determined by reference to, the functional currency of the taxpayer or qualified business unit of the taxpayer (even if that currency is other than the U.S. dollar). See §1.988-2(b) to determine interest income or expense for debt instruments that provide for payments denominated in, or determined by reference to, a nonfunctional currency.

(h) *Example.* The following example illustrates the rules of this section.

Example. Allocation of unstated interest to deferred payments—(i) *Facts.* On July 1, 1996, A sells his personal residence to B for a stated purchase price of \$1,297,143.66. The property is not personal use property (within the meaning of section 1275(b)(3)) in the hands of B. Under the loan agreement, B is required to make two installment payments of \$648,571.83 each, the first due on June 30, 1998, and the second due on June 30, 2000. Both A and B use the cash receipts and disbursements method of accounting and use a calendar year for their taxable year.

(ii) *Amount of unstated interest.* Under section 483, the agreement does not provide for adequate stated interest. Thus, the loan's yield is the test rate of interest determined under §1.483-3. Assume that both A and B use annual accrual periods and that the test rate of interest is 9.2 percent, compounded annually. Under §1.483-2, the present value of the deferred payments is \$1,000,000. Thus, the agreement has unstated interest of \$297,143.66.

(iii) *First two accrual periods.* Under paragraph (d)(1) of this section, the issue price at the beginning of the first accrual period is \$1,000,000 (the amount described in §1.483-2(a)(1)(i)). Under paragraph (c) of this section, the amount of interest that accrues for the first accrual period is \$92,000 ($\$1,000,000 \times 0.092$) and the amount of interest that accrues for the second accrual period is \$100,464 ($\$1,092,000 \times 0.092$). Thus, \$192,464 of interest has accrued as of the end of the second accrual period. Under paragraph (e)(1) of this section, the \$648,571.83 payment made on June 30, 1998, is treated first as a payment of interest to the extent of \$192,464. The remainder of the payment (\$456,107.83) is treated as a payment of principal. Both A and B take the payment of interest (\$192,464) into account in 1998.

(iv) *Second two accrual periods.* The adjusted issue price at the beginning of the third accrual period is \$543,892.17 ($\$1,092,000 + \$100,464 - \$648,571.83$). The amount of interest that accrues for the third accrual period is \$50,038.08 ($\$543,892.17 \times 0.092$) and the amount of interest that accrues for the final accrual period is \$54,641.58, the excess of the amount payable at maturity (\$648,571.83), over the adjusted issue price at the beginning of the accrual period (\$593,930.25). As of the date the second payment becomes due, \$104,679.66 of interest has accrued. Thus, of the \$648,571.83 payment made on June 30, 2000, \$104,679.66 is treated as interest and \$543,892.17 is treated as principal. Both A and B take the payment of interest (\$104,679.66) into account in 2000.

(i) [Reserved]

(j) *Effective date.* This section applies to debt instruments issued on or after April 4, 1994, and to lending transactions, sales, and exchanges that

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occur on or after April 4, 1994. Taxpayers, however, may rely on this section for debt instruments issued after December 21, 1992, and before April 4, 1994, and for lending transactions, sales, and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994]

§ 1.446-3 Notional principal contracts.

(a) *Table of contents.* This paragraph (a) lists captioned paragraphs contained in § 1.446-3.

§ 1.446-3 Notional principal contracts.

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(i) Anti-abuse rule.

(j) Effective date.

(b) *Purpose.* The purpose of this section is to enable the clear reflection of the income and deductions from notional principal contracts by prescribing accounting methods that reflect the economic substance of such contracts.

(c) *Definitions and scope*—(1) *Notional principal contract*—(i) *In general.* A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself. Notional principal contracts governed by this section include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. A collar is not itself a notional principal contract, but certain caps and floors that comprise a collar may be treated as a single notional principal contract under paragraph (f)(2)(v)(C) of this section. A contract may be a notional principal contract governed by this section even though the term of the contract is subject to termination or extension. Each confirmation under a master agreement to enter into agreements governed by this section is treated as a separate notional principal contract.