OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: DISTRICT COUNSEL

Attention:

FROM: Joel E. Helke, Chief
Financial Institutions and Products Branch
Field Service Division

SUBJECT:

This Field Service Advice responds to your request for assistance . Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =
B =
C =
D =

E% =

F =

DATE 1 =
DATE 2 =
DATE 3 =
DATE 4 =

YEAR 1 =

ISSUES:

1. Whether the taxpayer may deduct original issue discount ("OID") on its contingent payments on the patent or patent rights that it purchased? How does Treas. Reg. § 1.1275-4 affect the taxpayer's computation of OID? How is the OID to be computed?

2. If the taxpayer acquired partnership interests, may the taxpayer deduct OID on the debt used to finance the purchase?

CONCLUSIONS:

1. The taxpayer may deduct OID on contingent payments either once the payments have become fixed or once the payments have been made, as of the payment date. The taxpayer is required to use the methodology under I.R.C. §§ 1271 - 1275 prior to the enactment of Treas. Reg. § 1.1275, and may look to the regulations that were proposed under sections 1271-1275 for guidance. The taxpayer may use any reasonable method in computing OID.

2. The taxpayer may be allowed to deduct OID to the same extent that it would otherwise be allowed to deduct OID, that is, either on payments that have become fixed or that have been made.

FACTS:

On DATE 4 a Field Service Advice was issued on this case. A more detailed version of the facts was presented in the prior FSA, and, therefore, only a brief recital of the facts is presented here.

A, the taxpayer, is a large D company. The taxpayer formed B on DATE 1. B was a partnership comprised of F limited partners, divided into Class A limited partners and Class B limited partners. None of the partnership interests, the debt instruments or the patents involved in this case are publicly traded.

The taxpayer and B entered into several agreements to license patent rights and technical information, and to finance research on a drug known as C.

The taxpayer exercised its right to purchase all of the Class A limited partnership interests on DATE 2, and notified the Class B limited partners in B of its intent to exercise its option to purchase the Class B interests in DATE 2. The taxpayer paid the limited partners in cash and also issued debt instruments to the limited partners, pursuant to which the taxpayer was obligated to make future payments to be paid quarterly. The future payments for the partnership interests were contingent upon the success and sales of the C and were to be made until YEAR 1. The payments have been fixed quarterly and have been paid within 60 days. The taxpayer determined the fair market value of the contingent payments on these debt instruments by projecting a E% annual growth in the sales of the C. No stated interest was provided for on these instruments. These instruments are the debt instruments at issue.

LAW AND ANALYSIS:

Pursuant to the final contingent payment regulations under Treas. Reg. § 1.1275-4(c), once a contingent payment is made, a portion of the payment is treated as interest and the remainder is treated as repayment of principal. The portion treated as interest is determined by discounting the payment from the date the payment was made to the issue date. In general, the test rate is the applicable federal rate that would apply to the debt instrument if the term of the instrument began on the date of the sale and ended on the date the contingent payment was made. The portion that is interest is then deductible by the taxpayer. § 163(e). Treas. Reg. § 1.1275-4(c) applies to debt instruments issued on or after August 13, 1996. However, the preamble to T.D. 8674, in which this regulation was adopted, stated that a taxpayer may use any reasonable method to account for a contingent payment debt instrument prior to August 13, 1996, including a method that would have been required under the proposed regulations that were outstanding when these instruments were issued.

Under the prior proposed regulations, a contingent payment was generally taken into account when the payment became fixed. This method of determining the OID on a contingent payment was employed in the contingent payment regulations proposed in 1986 as Prop. Treas. Reg. § 1.1275-4(c), reprinted in LR-189-84, 1986-1 C.B. 820, and also in the regulations proposed in 1994 as Prop. Treas. Reg. § 1.1275-4, and reprinted in FI-59-91, 1995-1 C.B. 894.

The regulation proposed in 1992 as Prop. Treas. Reg. § 1.1274-2(e), reprinted in FI-189-84, 1993-1 C.B. 734, was different from the prior proposed regulations and also different from the final regulations. This proposed regulation generally required a valuation of the contingent payments to determine the issue price. This proposed regulation did not affect how to determine the interest component of a contingent payment or when the interest was deductible, which were addressed by Prop. Treas. Reg. § 1.1275-4 in the prior proposed regulations.

The proposed regulations would allow the taxpayer to determine the interest portion when the payments were fixed, and the final regulations allow the taxpayer to determine the interest when the payments were made. The taxpayer may be given the choice of using either the date that the payments were fixed or made to calculate the issue price, and the imputed principal amount, by adding the present values of the payments pursuant to section 1274. The present value of the payments is determined by using a reasonable rate, for example the discount rate equal to the long-term applicable federal rate, from DATE 2 for the Class A interests and DATE 3 for the Class B interests. The amount in excess of the imputed principal amount is treated as interest. The interest component may be deducted in the taxable year in which the payment either became fixed or was made.

This discussion assumes that these instruments are debt instruments to the extent characterized by the taxpayer and by Examination and that sections 1271-1275 apply to this transaction. If the stream of contingent payments is determined to be properly characterized as other than a debt instrument, then section 483 may apply to this transaction to determine the unstated interest on the contract. The final regulations under section 483, Treas. Reg. § 1.483-4(a), provide that principal and interest on a contingent payment are calculated using the method provided in Treas. Reg. § 1.1275-4(c)(4), that is, the date the contingent payment is made to the issue date. Treas. Reg. § 1.483-4(a) applies to sales and exchanges that occur on or after August 13, 1996. The earlier proposed regulation, Prop. Treas. Reg. § 1.483-5(b)(3), LR-189-84, reprinted at 1986-1 C.B. 820, and revised by FI-189-84, reprinted at 1993-1 C.B. 734, allowed for a determination of principal and interest on contingent payments only once the payments became due. See also Treas. Reg. § 1.483-1(e) as it was in effect in 1993. Should the stream of contingent payments be characterized as other than a debt instrument, we ask that you request additional Field Service Advice.

The taxpayer may be allowed to deduct OID upon a purchase of a partnership interests to the same extent that it could deduct OID on a purchase of a patent or a patent right, unless the partners had different bases and the partnership did not make a partnership section 754 election. Please contact CC:DOM:FS:P&SI if you have any partnership questions. If you need clarification of this issue we will assist with the coordination.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

The taxpayer had determined the fair market value of the contingent payments by projecting a E% annual growth in the sales of the C. This method is not a reasonable method for calculating the OID (or the unstated interest) because the legislative history underlying these sections does not provide any support for the taxpayer’s method and the taxpayer has not demonstrated that its assumptions are reasonable.

The taxpayer’s proposed method is not allowable in light of the statutory authority, legislative history, existing regulations and case law. We conclude that the taxpayer may have the choice of using either the date the payments became fixed or the date the payments were made, although the taxpayer could not rely on the proposed regulations and generally the final regulations were not made final until after the date of the transaction. [redacted]