

# **Dealing with Debt & Interest**

## **Course Description & Study Guide**

This course brings the practitioner up-to-date information on tax issues affecting interest and debt. It covers the definition of bona fide debt, the avoidance of equity and lease treatment, imputed interest rates and debt modification. The various types of interest and their required allocation are explored and reviewed. For the economically troubled client, special attention is devoted to debt cancellation, repossession, discounts, and foreclosure. The program also discusses installment sales, equity participation debt, taxable interest, and bad debts.

**Completion Deadline & Exam:** This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

**Course Level: Overview.** This program is appropriate for professionals at all organizational levels.

**Field of Study:** Taxes

**Prerequisite:** General understanding of federal income taxation.

**Advanced Preparation:** None

## **Learning Assignments & Objectives**

As a result of studying each assignment, you should be able to meet the objectives listed below each assignment.

### **ASSIGNMENT**

### **SUBJECT**

#### **Chapter 1**

#### **Deductible Interest & Debt**

At the start of Chapter 1, participants should identify the following topics for study:

- \* Indebtedness

- \* Deductible interest & mortgage interest
- \* Investment interest
- \* Nondeductible interest
- \* Personal interest & capitalized interest
- \* At-risk rules
- \* Passive activity limitations
- \* Below-market interest rate loans
- \* Imputed interest on sales
- \* Original issue discount (OID)

### **Learning Objectives**

After reading Chapter 1, participants will be able to:

1. Determine “interest” and select how much is tax deductible under §163 by:
  - a. Identifying what constitutes bona fide debt considering economic substance and purpose and specifying how transactions with family members and controlled corporations can recharacterize alleged indebtedness into gift or business equity noting the factors used in this recharacterization; and
  - b. Specify the incentives to use corporate debt instead of equity, recognizing the special treatment of failed equity investment under §1244, and determining the differences among debt from installment sales, long-term and leveraged leases, and annuities.
2. Identify deductible interest noting special calculation concepts and procedures by:
  - a. Recognizing the allocation of interest based on the debt’s purpose noting the application of any carryover rules and determining net investment income noting its relationship investment interest deduction; and
  - b. Identifying the special tax treatment given to student loans, margin accounts, and market discount bonds noting what happens to any disallowed interest expense and specifying the timing considerations in interest reporting including interest paid in advance.
3. Identify nondeductible interest noting provisions that deny or restrict the deduction of interest by:
  - a. Recognizing when interest is nondeductible personal interest under §163(h)(1) and identifying the disallowance of interest related to tax-exempt income under §265, the life insurance interest restrictions of §264; the §465 at-risk limitations and the application of the §469 passive loss rules; and

b. Specifying the treatment of commitment fees and service charges based on R.R. 67-2897 and case law.

4. Recognize the deduction of interest using either the cash method or accrual method, determine the special elections applicable to and treatment of carrying charges under §266, below-market loans, imputed interest and original issue discount.

After studying the materials in Chapter 1, answer the exam questions 1 to 25.

**ASSIGNMENT**

**SUBJECT**

**Chapter 2**

**Allocation of Deductible Interest**

At the start of Chapter 2, participants should identify the following topics for study:

- \* Allocation period
- \* Proceeds not disbursed to borrower
- \* Proceeds deposited in borrower's account
- \* Accrued interest
- \* Loan proceeds received in cash
- \* Loan repayments
- \* Continuous borrowings
- \* Loan refinancing
- \* Debt-financed acquisitions
- \* Debt-financed distributions

**Learning Objectives**

After reading Chapter 2, participants will able to:

1. Determine the allocation of deductible interest based on the use and repayment of the loan proceeds and identify the special rules for the allocation of interest expense in connection with debt-financed acquisitions of, and distributions from, partnerships and S corporations.

After studying the materials in Chapter 2, answer the exam questions 26 to 30.

**ASSIGNMENT**

**SUBJECT**

**Chapter 3**

**Home Mortgage Interest**

At the start of Chapter 3, participants should identify the following topics for study:

- \* Secured debt
- \* Qualified home
- \* Special situations
- \* Points
- \* Mortgage interest statement - Form 1098

- \* Special rule for cooperative housing
- \* Home acquisition debt
- \* Home equity debt
- \* Mixed-use mortgages
- \* Grandfathered debt

### **Learning Objectives**

After reading Chapter 3, participants will able to:

1. Identify categories of mortgages and characteristics of secured debt that influence the deductibility of interest, “qualified home,” and special situations affecting mortgage interest.
2. Specify special situations that can impact the qualified home mortgage interest deduction.
3. Recognize the general rule for the tax treatment of points noting exceptions, determine when a taxpayer will receive a *Mortgage Interest Statement* – Form 1098 and which information is included on this statement to figure interest deductions.
4. Identify when a stock in a cooperative housing corporation owned by a tenant-stockholder is a qualified home allowing for a deduction of interest paid, and specify the limits on the home mortgage deduction to ensure that appropriate deductions are taken.

After studying the materials in Chapter 3, answer the exam questions 31 to 42.

<b>ASSIGNMENT</b>	<b>SUBJECT</b>
<b>Chapter 4</b>	<b>Taxable Interest</b>

At the start of Chapter 4, participants should identify the following topics for study:

- \* Dividends v. interest
- \* CDs & deferred interest accounts
- \* U.S. obligations
- \* Miscellaneous interest items
- \* U.S. savings bonds
- \* Education Savings Bond Program
- \* Bonds sold between interest dates
- \* Insurance
- \* Taxable interest on state or local government obligations
- \* Tax-exempt bonds bought at a discount

### **Learning Objectives**

After reading Chapter 4, participants will able to:

1. Identify distinctions between dividends and interest noting the taxability of interest on CDs, deferred interest accounts, frozen deposits, and U.S. obligations and specify the treatment of other miscellaneous interest items.
2. Recognize the types of U.S. savings bonds noting their tax advantages and disadvantages, identify the tax treatment of bonds sold between interest dates, and determine when life insurance proceeds are taxable or excludable from income.
3. Identify state and local government debt obligations noting the nature of the activity they fund and their impact on whether the interest received from them is taxable.

After studying the materials in Chapter 4, answer the exam questions 43 to 51.

<b>ASSIGNMENT</b>	<b>SUBJECT</b>
<b>Chapter 5</b>	<b>Installment Sales</b>

At the start of Chapter 5, participants should identify the following topics for study:

- \* Installment method
- \* Installment income
- \* Imputed interest & OID
- \* Related party sales
- \* Like-kind exchanges
- \* Contingent payments or price
- \* Sale of a business
- \* Dealer dispositions
- \* Installment notes in excess of \$5 million
- \* Dispositions of installment obligations

### **Learning Objectives**

After reading Chapter 5, participants will be able to:

1. Recognize the importance of the installment method and, specify the §453 requirements and basic terminology associated with using the installment method.
2. Determine the impact of §483 (imputed interest rules) and §§1271 through 1274 (original issue discount rules) on installment sales, and identify the §1038 repossession rules that apply to repossessions by sellers and repossessions of principal residences.
3. Specify the rules associated with real property sales and casual sales of personalty, the provisions associated with the related party rules of §453 and the exceptions that override basic installment planning, iden-

tify regulations governing like-kind exchanges noting their impact on delayed exchanges and recognize the development and application the contingent payment rules.

4. Determine the allocation of payments for a single sale of several assets among different classes according to R.R. 76-110, identify the §1060 residual method to report the sale of a business, and identify “dealer dispositions” noting when installment reporting may not be used.

5. Recognize the interest payable on installment dispositions exceeding \$5 million and specify the circumstances when dispositions of installment obligations occur.

After studying the materials in Chapter 5, answer the exam questions 52 to 70.

<b>ASSIGNMENT</b>	<b>SUBJECT</b>
<b>Chapter 6</b>	<b>Repossession</b>

At the start of Chapter 6, participants should identify the following topics for study:

- \* Repossession of personal property
- \* Non-installment method sales
- \* Installment method sales
- \* Basis of repossessed personal property
- \* Bad debt
- \* Repossession of real property
- \* Figuring gain on repossession
- \* Seller’s former home exception

**Learning Objectives**

After reading Chapter 6, participants will able to:

1. Identify the variables that determine which §1038 rules for repossessions apply, and determine basis and gain or loss resulting from repossession of personal property using installment method and the non-installment method sales.
2. Specify the distinctions between the rules, calculations and effects of repossessions of personal and real property, and identify when a §166 bad debt deduction may be taken if the seller repossesses real property.

After studying the materials in Chapter 6, answer the exam questions 71 to 78.

<b>ASSIGNMENT</b>	<b>SUBJECT</b>
<b>Chapter 7</b>	<b>Debt Cancellation &amp; Foreclosure</b>

At the start of Chapter 7, participants should identify the following topics for study:

- \* Income inclusion rule & exceptions
- \* Real property business debt exclusion
- \* General ordering of tax attribute reduction
- \* Basis reduction
- \* Individual and partnership bankruptcies
- \* Corporate stock-for-debt rule
- \* S corporation bankruptcy
- \* Reporting
- \* Amount realized on sale or other distribution of property
- \* Discounted acquisition of debt

### **Learning Objectives**

After reading Chapter 7, participants will be able to:

1. Recognize the effect that debt cancellation has on net worth and potential income inclusion from cancellation of indebtedness income, and specify exceptions to the general income inclusion rule noting their tax impact.
2. Identify tax attribute reductions noting their application when reducing canceled debt, cite the special basis reduction rules, recognize the depreciable property election in reducing the basis of depreciable property before reducing any other tax attributes, determine what constitutes individual, partnership and S corporation bankruptcy, and specify the variables used in determining whether shares of stock issued to a creditor are nominal or token.
3. Determine gain or loss resulting from foreclosure or repossession noting reporting and filing requirements, specify the timing and character of the gain or loss, and cite the hidden income tax danger of directly or indirectly acquiring one's own debt at a discount.

After studying the materials in Chapter 7, answer the exam questions 79 to 89.

### **ASSIGNMENT**

### **SUBJECT**

#### **Chapter 8**

#### **Equity Participation Debt**

At the start of Chapter 8, participants should identify the following topics for study:

- \* Shared appreciation mortgages - SAMs
- \* Types of equity participation debt
- \* Contingent interest as the measure & means of equity participation
- \* Basic tests to establish interest

- \* Partnership recharacterization - Culbertson Rule
- \* Tax consequences of debt recharacterization
- \* The “true” option rule
- \* Convertible indebtedness
- \* Imputed interest & original issue discount
- \* Accounting treatment

### **Learning Objectives**

After reading Chapter 8, participants will able to:

1. Recognize the mechanics of equity participation debt noting the use of this financing option to clients by:
  - a. Identifying equity participation loans noting the lender’s role in each and common elements and characteristics of shared appreciation loans noting key terms; and
  - b. Specify the economic aspects of shared appreciation mortgages including the tax treatment of shared appreciation mortgages based on the hybrid concept and R.R. 83-51.
2. Determine the types of equity participation debt by:
  - a. Specifying the basic tests for loans where “interest” is measured in whole or in part by equity participation, the importance of the Culbertson rule and the risk of partnership status;
  - b. Identifying the tax consequences of being a property owner and the recharacterization of debt based on the failure to find a debtor-creditor relationship between the borrower and lender; and
  - c. Specifying the conversion and option rights associated with equity participation debt noting the application to debt instruments of the time value of money provisions of imputed interest and original issue discount.

After studying the materials in Chapter 8, answer the exam questions 90 to 100.

### **ASSIGNMENT**

### **SUBJECT**

#### **Chapter 9**

#### **Foreign Interest Withholding**

At the start of Chapter 9, participants should identify the following topics for study:

- \* Fixed or determinable annual or periodic income
- \* Interest paid by U.S. obligors & interest paid to controlling foreign corporations
- \* Interest on real property mortgages
- \* Interest paid by foreign corporations
- \* Interest on tax-free covenant bonds



- \* Interest on deposits
- \* Payer having income from abroad
- \* Bankers' acceptances
- \* Sales of bonds between interest dates
- \* Portfolio interest

### **Learning Objectives**

After reading Chapter 9, participants will able to:

1. Recognize the general tax treatment of interest received from sources within the United States, and identify the tax treatment of foreign interest by:
  - a. Specifying types of interest paid to foreign payees that are subject to withholding noting how to figure the tax;
  - b. Identifying the requirements of tax treaties to ensure entitlement to benefits under the tax treaty and specifying statutory withholding rates for tax-free covenant bond interest; and
  - c. Determining the types of interest of U.S. obligors that are not subject to withholding and the conditions of their exemption.

After studying the materials in Chapter 9, answer the exam questions 101 to 105.

<b>ASSIGNMENT</b>	<b>SUBJECT</b>
<b>Chapter 10</b>	<b>Bad Debts</b>

At the start of Chapter 10, participants should identify the following topics for study:

- \* Totally worthless bad debts
- \* True debt
- \* Mechanics' liens
- \* Reporting & recovery
- \* Credit transactions
- \* Former business bad debts
- \* Insolvency of partner
- \* Business loan guarantees
- \* Specific charge-off method
- \* Nonaccrual-experience accounting method

### **Learning Objectives**

After reading Chapter 10, participants will able to:

1. Identify bad debt categories noting their tax treatment and effect on accounting and reporting by:
  - a. Determining the concepts of worthlessness and true debt including the unique characteristics of deductible nonbusiness bad debt;

