

Internal Revenue Code Section 163(e)(1)

Interest

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(e) Original issue discount.

(1) In general.

The portion of the original issue discount with respect to any debt instrument which is allowable as a deduction to the issuer for any taxable year shall be equal to the aggregate daily portions of the original issue discount for days during such taxable year.

(2) Definitions and special rules.

For purposes of this subsection -

(A) Debt instrument. The term "debt instrument" has the meaning given such term by section 1275(a)(1) .

(B) Daily portions. The daily portion of the original issue discount for any day shall be determined under section 1272(a) (without regard to paragraph (7) thereof and without regard to section 1273(a)(3)).

(C) Short-term obligations. In the case of an obligor of a short-term obligation (as defined in section 1283(a)(1)(A)) who uses the cash receipts and disbursements method of accounting, the original issue discount (and any other interest payable) on such obligation shall be deductible only when paid.

(3) Special rule for original issue discount on obligation held by related foreign person.

(A) In general. If any debt instrument having original issue discount is held by a related foreign person, any portion of such original issue discount shall not be allowable as a deduction to the issuer until paid. The preceding sentence shall not apply to the extent that the original issue discount is effectively connected with the conduct by such foreign related person of a trade or business within the United States unless such original issue discount is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

(B) Special rule for certain foreign entities.

(i) In general. In the case of any debt instrument having original issue discount which is held by a related foreign person which is a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the issuer with respect to such original issue discount for any taxable year before the taxable year in which paid only to the extent such original issue discount is includible (determined without regard to

properly allocable deductions and qualified deficits under section 952(c)(1)(B)) during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

(ii) Secretarial authority. The Secretary may by regulation exempt transactions from the application of clause (i) , including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged.

(C) Related foreign person. For purposes of subparagraph (A) , the term "related foreign person" means any person-

(i) who is not a United States person, and

(ii) who is related (within the meaning of section 267(b)) to the issuer.

(4) Exception.

This subsection shall not apply to any debt instrument described in section 1272(a)(2)(D) (relating to loans between natural persons).

(5) Special rules for original issue discount on certain high yield obligations.

(A) In general. In the case of an applicable high yield discount obligation issued by a corporation-

(i) no deduction shall be allowed under this chapter for the disqualified portion of the original issue discount on such obligation, and

(ii) the remainder of such original issue discount shall not be allowable as a deduction until paid.

For purposes of this paragraph , rules similar to the rules of subsection (i)(3)(B) shall apply in determining the amount of the original issue discount and when the original issue discount is paid.

(B) Disqualified portion treated as stock distribution for purposes of dividend received deduction.

(i) In general. Solely for purposes of sections 243 , 245 , 246 , and 246A , the dividend equivalent portion of any amount includible in gross income of a corporation under section 1272(a) in respect of an applicable high yield discount obligation shall be treated as a dividend received by such corporation from the corporation issuing such obligation.

(ii) Dividend equivalent portion. For purposes of clause (i) , the dividend equivalent portion of any amount includible in gross income under section 1272(a) in respect of an applicable high yield discount obligation is the portion of the amount so includible-

(I) which is attributable to the disqualified portion of the original issue discount on such obligation, and

(II) which would have been treated as a dividend if it had been a distribution made by the issuing corporation with respect to stock in such corporation.

(C) Disqualified portion.

(i) In general. For purposes of this paragraph, the disqualified portion of the original issue discount on any applicable high yield discount obligation is the lesser of-

(I) the amount of such original issue discount, or

(II) the portion of the total return on such obligation which bears the same ratio to such total return as the disqualified yield on such obligation bears to the yield to maturity on such obligation.

(ii) Definitions. For purposes of clause (i), the term "disqualified yield" means the excess of the yield to maturity on the obligation over the sum referred to in subsection (i)(1)(B) plus 1 percentage point, and the term "total return" is the amount which would have been the original issue discount on the obligation if interest described in the parenthetical in section 1273(a)(2) were included in the stated redemption price at maturity.

(D) Exception for S corporations. This paragraph shall not apply to any obligation issued by any corporation for any period for which such corporation is an S corporation.

(E) Effect on earnings and profits. This paragraph shall not apply for purposes of determining earnings and profits; except that, for purposes of determining the dividend equivalent portion of any amount includible in gross income under section 1272(a) in respect of an applicable high yield discount obligation, no reduction shall be made for any amount attributable to the disqualified portion of any original issue discount on such obligation.

(F) Suspension of application of paragraph.

(i) Temporary suspension. This paragraph shall not apply to any applicable high yield discount obligation issued during the period beginning on September 1, 2008, and ending on December 31, 2009, in exchange (including an exchange resulting from a modification of the debt instrument) for an obligation which is not an applicable high yield discount obligation and the issuer (or obligor) of which is the same as the issuer (or obligor) of such applicable high yield discount obligation. The preceding sentence shall not apply to any obligation the interest on which is interest described in section 871(h)(4) (without regard to subparagraph (D) thereof) or to any obligation issued to a related person (within the meaning of section 108(e)(4)).

(ii) Successive application. Any obligation to which clause (i) applies shall not be treated as an applicable high yield discount obligation for

purposes of applying this subparagraph to any other obligation issued in exchange for such obligation.

(iii) Secretarial authority to suspend application. The Secretary may apply this paragraph with respect to debt instruments issued in periods following the period described in clause (i) if the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital markets.

(G) Cross reference. For definition of applicable high yield discount obligation, see subsection (i) .

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