

*Smith file*

TO: FORMER SHAREHOLDERS OF MEGADIAMOND INDUSTRIES, INC.

FROM: *Ken Van Haren*  
KEN VAN HAREN, DIRECTOR OF TAXES

DATE: JANUARY 29, 1988

SUBJECT: 1987 FORM 1099

During 1987, payments became due pursuant to the share purchase agreement for Megadiamond Industries, Inc. dated February 13, 1985. As indicated in the agreement, a portion of each payment is considered interest income under federal tax regulations. Accordingly, a Form 1099 is enclosed which shows the interest portion of payments made and accrued in 1987.

The computation of interest was made by the accounting firm of Arthur Andersen & Co., pursuant to Prop. Reg. 1.1275-4(c), a copy of which is attached for your reference. The 1987 interest amount was computed on actual payments due in February, March and May, plus the payment which became fixed in late 1987 (but which will not be paid until February, 1988).

If you have any questions concerning the interest computation, please contact Jackie Jank at (714) 476-6244.

KVH/pgp

Enclosure

CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code <b>Smith International, Inc. 4490 Von Karman Avenue Newport Beach, Ca. 92660</b>		1 Total original issue discount for 1987* <b>\$ 20,565.97</b>	OMB No. 1545-0117 <b>1987</b>	<b>Original Issue Discount</b>
PAYER'S Federal identification number <b>95-3822631</b>		2 Other periodic interest <b>\$</b>	Statement for Recipients of	
RECIPIENT'S name (first, middle, last) <b>Ida Rose Hall</b>	RECIPIENT'S identification number <b>529-10-1716</b>	3 Early withdrawal penalty <b>\$</b>	4 Federal income tax withheld <b>\$</b>	<b>Copy B For Recipient</b> This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address <b>1711 N. Lambert Lane</b>	City, state, and ZIP code <b>Provo, Utah 84601</b>	5 Description <div style="background-color: #cccccc; height: 40px;"></div>		
Account number (optional)	* This may not be the correct figure to be reported on your income tax return. See instructions.			

**Proposed Reg. §1.1275-4**

**0-17 [132,933.31] Proposed Reg. §1.1275-4 Contingent payments. (Proposed Treasury Decision, published 4-8-86.)**

(a) **Applicability.** The rules of this section apply to debt instruments that provide for one or more contingent payments (as defined in paragraph (b) of this section). Contingent payments under a debt instrument subject to section 1274 are governed by the provisions of paragraphs (c) or (d), whichever is applicable. Contingent payments under a debt instrument issued for cash or publicly traded property are governed by the provisions of paragraphs (e) or (f), whichever is applicable. Nothing in this section or in the regulations under sections 1271 through 1274 shall influence whether an instrument calling for contingent payments is properly treated as debt or equity, or whether such instrument evidences a valid indebtedness for Federal income tax purposes.

(b) **Definition of contingent payment—(1) In general.** In determining whether a payment called for under a debt instrument is a contingent payment, remote and incidental contingencies may be disregarded by the Commissioner. The parties to the transaction, however, are bound by its form. Thus, neither party may treat any amount under a debt instrument whose payment is subject to a stated contingency as noncontingent. A payment shall not be considered a contingent payment merely because the amount of or the liability for the payment may be impaired by insolvency or default. Variable payments of interest based on current values of an objective interest index (as defined in

**Proposed Reg. §1.1275-4(b)(1) continued**

§1.1275-5), if made under a debt instrument issued for cash or publicly traded property to which §1.1275-5(a) applies or if made under a debt instrument to which §1.1274-3(d)(1)(i) applies, shall not be treated as contingent payments, and if made under a debt instrument to which §1.1274-3(d)(1)(i) does not apply, shall be treated as contingent payments to the extent provided in §1.1274-3(d)(1)(iv).

(2) **Certain debt instruments providing for payments contingent only as to time.** In the case of a debt instrument that calls for fixed or minimum payments of principal uncertain as to the time of payment, and that calls for payments of interest on the unpaid principal balance at a fixed or variable rate (which, in a transaction subject to section 1274, constitutes adequate stated interest), such payments shall not be treated as contingent payments (within the meaning of paragraph (b) of this section) and the provisions of §§1.1272-1(c) (in the case of a fixed rate) or §§1.1272-1(f)(3)(ii) and 1.1275-5(d) (in the case of a variable rate) shall apply to determine the amount of original issue discount allocable to each accrual period under the debt instrument. See §1.1272-1(k), Example (14). Payments of principal in excess of the minimum amount of principal (other than payments of principal accompanied by adequate stated interest), however, shall be treated as contingent payments.

(c) **Debt instruments subject to section 1274—(1) Separation into noncontingent and contingent components.** Except as otherwise provided in section 1274 and the regulations thereunder, in the case of a debt instrument (the "overall debt instrument") subject to section 1274 that calls for one or more contingent payments (other than a debt instrument described in paragraph (d) of this section), the noncontingent payments shall be subject to the rules described in paragraph (c)(2) of this section, and the contingent payments shall be accounted for separately under the provisions of paragraphs (c)(3) of this section.

(2) **Treatment of noncontingent payments.** The noncontingent payments under an overall debt instrument described in paragraph (c)(1) of this section shall be treated under sections 1271 through 1275 and the regulations thereunder as a separate noncontingent debt instrument. The issue price of this separate noncontingent debt instrument is the issue price of the overall debt instrument, determined under §§1.1274-2(b) and 1.1274-3(d)(2) (if applicable). The stated redemption price at maturity is determined under §1.1273-1(b)(1), and yield is determined under §1.1272-1(f), both without reference to the contingent payments. The de minimis rule of section 1273(a)(3) and §1.1273-1(a)(3) shall not apply to the noncontingent debt instrument.

(3) **Treatment of contingent payments—(i)** In general. Except as provided in paragraph (c)(3)(iii) of this section, the portion of the payment treated as interest is includible in gross income by the holder and deductible from gross income by the issuer in their respective taxable years in which the amount of the payment becomes fixed.

(ii) **Recharacterization of certain contingent payments.** Any contingent payment made under a debt instrument to which section 1274 applies, other than a contingent principal payment accompanied by a payment of adequate stated interest, shall be treated as consisting of—

(A) A payment of principal in an amount equal to the present value of the payment, determined by discounting the payment at the test rate (using the exact method for short periods) from the date that the amount of the payment becomes fixed to the issue date, and

(B) A payment of interest in an amount equal to the excess of the total amount of the payment over the amount treated as principal.

The preceding sentence notwithstanding, the total amount treated as principal under an overall debt instrument to which section 1274 applies that calls for a fixed or a maximum stated principal amount shall not exceed this fixed or maximum stated principal amount. Once the total of the noncontingent principal payments due under the debt instrument and the portion of the contingent payments treated as principal exceeds the amount described in the preceding sentence, any additional contingent payments shall be treated entirely as interest.

**Original Issue Discount (OID) Rules    32,864-Z.25**  
**(§1271—1275)**

**Proposed Reg. §1.1275-4(c)(3) continued**

(iii) Certain delayed contingent payments—(A) In general. In the case in which a contingent payment is not due within six months of the date on which the amount of the payment becomes fixed, the parties shall be treated as if the borrower had issued a separate debt instrument on the date the amount of the payment becomes fixed, maturing on the date that the payment is due. This separate debt instrument shall be treated as a debt instrument to which section 1274 applies. The stated principal amount of this separate debt instrument shall be the amount of the payment that becomes fixed. An amount equal to the issue price of this debt instrument shall be characterized as interest or principal under the rules of paragraph (c)(3)(ii) of this section and accounted for under paragraph (c)(3)(i) of this section, as if an amount equal to the issue price had been paid by the borrower to the lender on the date that the amount of the payment becomes fixed. To determine the issue price of the separate debt instrument, all payments under the debt instrument shall be discounted from the maturity date to the date that the amount of the payment becomes fixed. The amount of a contingent payment shall be treated as fixed even if, once fixed, the payment is payable in the future together with interest that is subject to further contingencies.

(B) Special rules. In applying section 1274 to a separate debt instrument described in paragraph (c)(3)(iii)(A) of this section, any provision calling for a test rate other than the applicable Federal rate shall apply if, and only if, such provision applies to the overall debt instrument. (For example, the 9 percent maximum discount rate of section 1274A(a) and §1.1274A-1(a) applies if the overall debt instrument satisfies the test of §1.1274A-1(b)(3)). The test rates under paragraph (c)(3)(ii) and (c)(3)(iii)(A) of this section shall be based on the applicable Federal rates in effect on the date of the sale or exchange (or, if applicable, the contract date), and shall be based on a term beginning on the date the overall debt instrument is issued and ending on the date the contingent payment is due.

(4) **Examples.** The provisions of paragraph (c) of this section may be illustrated by the following examples:

**Example (1).** (i) A owns Blackacre, unencumbered depreciable real estate. On April 1, 1986, A sells Blackacre to B for a stated purchase price of \$6,000,000. B makes a down payment of \$1,000,000 and issues to A a debt instrument calling for \$5,000,000 to be paid in 5 years, with fixed interest of 6% and contingent interest of up to an additional 8%. Both fixed and contingent interest are payable annually on March 31 of each year from 1987 to 1991. The contingent interest payment in each year is calculated according to a formula that depends on the gross rents B receives from Blackacre during the preceding calendar year. Assume that B's debt instrument does not have adequate stated interest under §1.1274-3, that the Federal short-term rate is 10%, compounded annually, and that the Federal mid-term rate is 11%, compounded annually.

(ii) The issue price of B's noncontingent debt instrument under paragraph (c)(2) of this section is determined by considering only the five fixed interest payments of \$300,000 and the principal payment of \$5,000,000. The present value, under §1.1274-5, of the fixed payments under the overall debt instrument, using a discount rate equal to the Federal mid-term rate of 11%, compounded annually, is \$4,076,025.75. This amount is also the issue price of the noncontingent debt instrument. B's basis in Blackacre is thus initially limited to \$5,076,025.75 (\$1,000,000 down payment plus \$4,076,025.75 issue price of the noncontingent debt instrument). B's noncontingent debt instrument has imputed interest of \$923,974.25 under section 1274, which is treated as original issue discount subject to current inclusion under section 1272 and the regulations thereunder.

(iii) Assume that the amount of contingent interest that becomes fixed as of December 31, 1986, is \$100,000. This amount is treated under paragraph (c)(3)(ii)(A) of this section as a payment of principal to the extent of its present value (using a discount rate equal to the Federal short-term rate of 10%, compounded annually, and the exact method for the short period), discounting from December 31, 1986, (the date the amount of the payment becomes fixed) to April 1, 1986 (the issue date of B's debt instrument) which,