Discount Obligations -- Capital Gain or Ordinary Income

Melvin M. Greenberg

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Introduction

The rise in ordinary income rates has resulted in a constant striving by taxpayers to convert ordinary income into capital gain. One vehicle utilized in an attempt to achieve this desired result is the discount obligation.

A discount obligation is an obligation issued for a consideration less than the amount of the debt. For example, a corporation may issue a bond for $750, redeemable in ten years at $1000. The bond may or may not stipulate additional interest to be paid periodically. It must be decided whether the difference between the consideration paid and the debt due is capital gain or ordinary income. This question, although infrequently litigated, has been the subject of much confusion.

Section 1232 of the Internal Revenue Code of 1954 unravelled the puzzle for discount obligations issued after December 31, 1954.[1] On the sale or exchange[2] of certain discount obligations, the gain attributable to an original issue discount will be considered as gain from the sale or exchange of property which is not a capital asset.[3]

What is the nature of the gain attributable to an original issue discount realized on the sale or exchange or retirement of a discount obligation issued on or before December 31, 1954? Under Section 1232, the applicable statutory provision remains substantially unaltered[4] for obligations issued on or before this date.

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1. INT. REV. CODE OF 1954 § 1232 superseded § 117 (f) of the INT. REV. CODE OF 1939.

2. INT. REV. CODE OF 1954 § 1232 (a) (1) characterizes a retirement of qualified obligations as a "sale or exchange." The provisions of § 1232 (a)(2) are therefore equally applicable to retirements.

3. INT. REV. CODE OF 1954 § 1232 (a)(2)(A) provides as follows:

> . . . upon sale or exchange of bonds or other evidence of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed an amount which bears the same ratio to the original issue discount . . . as the number of complete months that the bond or other evidences of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity, shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

4. INT. REV. CODE OF 1954 § 1232 added the requirement that the obligation be a capital asset in the hands of the taxpayer. For obligations issued after Dec. 31, 1954 it is no longer required that the obligation be issued either in registered form or with interest coupons.

This analysis is an examination of the problem as it existed under Section 117(f) of the Internal Revenue Code of 1939[5] and still exists under the Internal Revenue Code of 1954.

Assume the following situation: A taxpayer purchases a bond[6] issued by a corporation[7]; it is a capital asset in his hands. The bond is issued to the taxpayer at an original discount. In the following transactions, is ordinary income or capital gain realized by the taxpayer?

(1) The taxpayer holds the bond to maturity at which time the corporation redeems it. The bond was not issued with interest coupons or in registered form.

(2) The taxpayer holds the bond to maturity at which time the corporation redeems it. The bond was issued either with interest coupons or in registered form.

(3) The taxpayer makes a bona fide sale of the bond to a third party one day before maturity. In this situation it should make no difference whether the bond was issued with interest coupons or in registered form since there was an actual sale.

HYPOTHETICAL I: NON-COUPON, NON-REGISTERED BOND REDEEMED AT MATURITY

Before a taxpayer may ever realize capital gain there must be a "sale or exchange."[8] If there is no sale or exchange, the problem of ascertaining whether the property disposed of is a capital asset becomes moot.

Prior to the enactment of Section 117(f)[9], there was some conflict as to whether the redemption of a bond constituted a sale or exchange. A few early decisions held that proceeds received by a holder upon redemption were amounts received in exchange.[10] Subsequent decisions, however, reversed the rule,[11] and the Bureau followed the latter.[12] Any doubt concerning the law prior to Section 117(f) was finally dispelled by the Supreme Court of the United States in *United States v. Fairbanks.*[13] There the Court held that Section 117(f) was not declaratory of pre-existing law, but constituted a material addition to prior law and that without Section 117(f), "payment and discharge of a bond is neither sale nor exchange within the commonly accepted meaning of the words."[14]

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5. INT. REV. CODE OF 1939 § 117 (f).
6. Includes debentures, notes, certificates or other evidences of indebtedness.
7. Includes government or political subdivision therof.
8. INT. REV. CODE OF 1939 § 117 (a)(4).
9. Revenue Act of 1934, 48 STAT. 680.
10. Commissioner v. Werner, 15 B.T.A. 482 (1929); see also Averill v. Commissioner, 101 F.2d 644 (1st Cir. 1938).
11. 27 B.T.A. 463 (1932); see also Felin v. Kyle, 102 F.2d 349 (3rd Cir. 1939).
12. I.T. 2678, XI-1 Cum. Bull. 117 (1933).
13. 306 U.S. 436 (1939).
14. *Id.* at 437.

Section 117(f) was first enacted in 1934[15] and has remained unchanged. It read:

> [A]mounts received by the holder upon the retirement of bonds . . . issued by any corporation . . . with interest coupons or in registered form shall be considered as amounts received in exchange therefor.[16]

Thus, Congress declared a redemption to be equivalent to a sale or exchange. The section, however, requires that the bond be issued either with interest coupons or in registered form. The hypothetical situation under discussion, in which the bond has no attached interest coupons nor is in registered form, fails, therefore, to satisfy the express conditions requisite to qualifying a transaction for the special treatment accorded by Section 117(f). As previously noted, without the benefit of Section 117(f) a redemption is not a sale or exchange, and without a sale or exchange there cannot be capital gain.

Hence, it can be concluded that where a taxpayer holds until maturity an unregistered bond without interest coupons, the gain realized upon redemption is ordinary income.

Hypothetical II: Coupon or Registered Bond Redeemed at Maturity

In this situation the bond falls within the definition of Section 117(f) and therefore its retirement is characterized as a "sale or exchange." The taxpayer here may realize gain as a result of an original discount. It is arguable that this discount is equivalent to interest. If so, it would seem that the general language of Section 117(f) falls short of converting what otherwise would have been ordinary income into capital gain.

In *Commssioner v. Caulkins,*[17] the Court of Appeals for the Sixth Circuit was confronted with a similar fact situation. There the taxpayer had purchased a certificate prior to November 7, 1938, for $15,043.22 On April 1, 1939, he surrendered the certificate and received $20,000, the agreed redemption value. The issuing corporation reported the difference as interest. The taxpayer deducted the realized gain as long term capital gain. Concluding that the discount was essentially equivalent to interest, the court stated:

> . . . it is difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income. The fact that the contract does not provide for equal

15. See note 9 *supra.*
16. See note 1 *supra.*
17. 144 F.2d 482 (6th Cir. 1944).

> amounts of interest to be set aside each year, available to the holder, does not affect the question. The increment is consideration paid for the use of the principal sum. Unfortunately for the Commissioner's contention, Congress has not made the differentiation.[18]

The court reasoned that the language of Section 117(f) precluded any other finding than that of capital gain:

> In the present case, the promise was to pay $20,000 at the expiration of the ten year period. Clearly $20,000 was the amount received on the retirement of the certificate and under the plain wording of Section 117(f), it was taxable as a capital gain.[19]

The Internal Revenue Service acquiesced[20] in the *Caulkins* decision. Subsequent to the *Caulkins* case, however, the Treasury promulgated Revenue Ruling 119.[21] The latter ruling dealt with non-interest bearing obligations of the State of Israel issued in registered form and sold at a discount. The Treasury concluded that the gain realized on retirement would be ordinary income notwithstanding Section 117(f) and the *Caulkins* decision. The ruling rested on three major grounds which appear untenable. It equated the treatment accorded the discount on Series E United States savings bonds with that to be accorded Israeli bonds. However there is a distinction. In the case of Series E bonds, the discount is treated as interest because of special legislation not applicable to the discount on Israeli bonds.[22] The Treasury Department assumed that gain realized on retirement of state obligations issued at discount is treated as interest.[23] However, the Internal Revenue Service has vacillated in its treatment of state bond discount, sometimes holding it to be capital gain, not interest.[24] Finally, the effect of the ruling is to limit the *Caulkins* case to its facts. There is no justification for any such limitation. An acceptance of the *Caulkins* decision necessarily leads to capital gain treatment for any qualified discount bond. In 1955, the Service conceded that the *Caulkins* rationale is general in its application[25] and withdrew acquiescence.[26] The Service will continue to treat such discount as ordinary income.[27]

The question remaining to be resolved is whether the *Caulkins* case is to be followed or whether the 1955 revenue ruling reaches the correct result.

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18. *Id.* at 484.
19. *Ibid.*
20. I.T. 1711-1996 CUM. BULL. 5. (1944).
21. IR-Mimm. 43 CUM. BULL. 112 (1952).
22. 46 STAT. 19 (1930), 31 U.S.C. § 754 (1953).
23. G.C.M. 10452, XI-1 CUM. BULL. 18 (1932).
24. 1-1 CUM. BULL. 27 (1922).
25. REV. RUL. 55-136, 1955 INT. REV. BULL. No. 11, at 12.
26. 1955 INT. REV. BULL. No. 11, at 6.
27. See note 22 *supra*; see also REV. RUL. 55-135, 1953 INT. REV. BULL. No. 11, at 12.

Interest is taxable as ordinary income.[28] The term interest has been defined by the Supreme Court, as, "compensation for the use or forbearance of money."[29] Where a taxpayer purchases a bond at a discount the increment received on retirement is compensation for the use of the money borrowed. The discount is the cost of obtaining the loan and is the equivalent of interest. It appears illogical to distinguish between a bond bought at a discount and interest periodically paid or accrued. Both are for the use or forbearance of money, the only difference being the method of payment. This increment in value attributable to interest can be separated from the capital investment.[30]

The *Caulkins* decision held that the "plain wording" of Section 117(f) requires capital gain treatment. However the language of Section 117(f) does not require this conclusion. The court decided that since "amounts received" are "considered as amounts received in exchange therefor," the gain resulting must be capital gain. But such amounts must still be received in exchange for a capital asset.[31] If in the *Caulkins* case the taxpayer had been a dealer in securities, it is plain that the court would have found the gain to be ordinary income. There would have been a sale or exchange, but not of a capital asset.[32] The words of Section 117(f) merely determine that the retirement of a bond or other security is to be treated as a "sale or exchange," it does no more.[33] To hold that the gain is capital, the discount must be a capital asset.

Having concluded that Section 117(f) merely furnishes the element of "sale or exchange," the principles of *Hort v. Commissioner,*[34] *Helvering v. Horst,*[35] and *Rhodes' Estate v. Commissioner*[36] should apply. In *Hort,* a lessor received payment in consideration for cancelling a lease. The court held that the payment was a substitute for rental payments and thus it was ordinary income. The right to receive rental payments, though property, was not considered a capital asset.

In *Helvering v. Horst,* the owner of a bond detached a negotiaable interest coupon before its due date and gave the coupon to his son. The court held that the assignment was not valid for tax purposes. The coupon, a mere right to receive income, was not property and could not be assigned by itself.

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28. INT. REV. CODE OF 1939 § 22(a).
29. Deputy v. DuPont, 308 U.S. 488 (1939); *accord.* Old Colony R.R. v. Commissioner, 284 U.S. 552 (1932); U.S. v. Collier, 104 F.2d 420 (5th Cir. 1939); Estate of Clarence E. Lehr, 18 T.C. 373 (1952).
30. Commissioner v. Tieselbock, 317 U.S. 399 (1943).
31. INT. REV. CODE OF 1939 § 117(a)(4).
32. INT. REV. CODE OF 1939 § 117(a)(1)(A).
33. Committee reports do not explain the intent of INT. REV. CODE OF 1939 § 117 (f); 1 CUM. BULL. 554, 557.
34. 313 U.S. 28 (1940).
35. 311 U.S. 112 (1940).
36. 131 F.2d 50 (6th Cir. 1942).

In *Rhodes' Estate,* the taxpayer owned 600 shares of stock in a corporation which had declared a dividend of twenty dollars per share. Before the dividend was paid, the taxpayer sold the right to receive the dividend. The court held that the taxpayer could not convert what would have been ordinary income into capital gain.

A strong argument can be made that *Helvering v. Horst* and *Rhode's Estate* are distinguishable from the facts in issue here. On retirement of the bond, in this hypothetical, the taxpayer relinquished his right to the entire property. In *Horst,* the taxpayer retained the bond, and in *Rhodes' Estate* he kept the stock. In *Helvering v. Horst,* the Supreme Court distinguished its prior decision in *Blair v. Commissioner*[37] by stating that in the *Blair* case the irrevocable assignment of the right to income from a trust was an assignment of the equitable ownership of the corpus itself and therefore valid. The Supreme Court, in *Horst* and *Blair,* was deciding who was the taxable entity, the donor or the donee. The conclusion reached was that where the right to receive income is assigned, the assignment will not be recognized unless the income-producing property is also assigned. The determination that the right to receive income is not property for tax purposes stands by itself. The *Caulkins* factual situation comes within the rule of *Fischer v. Commissioner*[38] and *Paine v. Commissioner,*[39] discussed under Hypothetical III.

Hence, when a bond issued either with interest coupons or in registered form is retired, the gain to its holder attributable to the discount should be treated as ordinary income.

Hypothetical III: Bond Sold Immediately Prior to Maturity

Before the enactment of Section 117(f) the courts recognized that certain sales prior to maturity could result in capital gain. In *McKee v. Commissioner,*[40] the taxpayer held two bonds as trustee. The bonds were sold one day before maturity. It was held that the taxpayer was entitled to favored treatment under Section 101(a), the capital gain provision of the 1928 law.[41] There was no discussion of the nature of the increase in value. However, it appears from the facts discussed that it was not interest. The court was careful to point out that the interest coupons which had matured were detached prior to sale. Capital gain treatment was also accorded the gain realized from the sale of preferred stock prior to redemption by the corporation.[42] Again there was no discussion concerning the nature of the gain. The corporation had redeemed at par value; this was in excess of the taxpayer's basis. The above cases are readily dis-

37. 300 U.S. 5 (1937).
38. 209 F.2d 513 (6th Cir. 1954), *cert. denied,* 347 U.S. 1014 (1954).
39. 23 T.C. No. 48 (1955).
40. 35 B.T.A. 239 (1937).
41. Revenue Act of 1928, § 101(z), 45 Stat. 791.
42. Hoby v. Commissioner, 2 T.C. 980 (1943).

tinguishable from the problem at hand. The increases in value do not appear attributable to any right to income, but rather to an increase in capital value.

In *Fischer v. Commissioner*,[43] the taxpayer sold interest notes which were in default both as to principal and interest. The unpaid interest amounted to approximately $75,000. The taxpayer, being on a cash receipts basis, reported the sum of $66,150.56 as a long term capital gain, that being the amount realized on the sale in excess of the face value of the notes. The Commissioner determined that the entire increment was taxable as ordinary income. It must be recognized that the notes were not purchased at a discount, but interest was payable periodically. The court, relying on the *Horst* and *Hort* doctrine, held for the Commissioner.

In *Paine v. Commissioner*,[44] the Tax Court was confronted with the sale before maturity of a non-registered discount note. The court concluded that the increment was interest and that the sale was bona fide. The taxpayer contended that the *Caulkins* case was controlling. In the *Caulkins* case the Tax Court found that where a taxpayer held a registered bond until maturity the gain realized was capital gain under Section 117(f). He argued that by selling the note before maturity he provided the "sale or exchange" element otherwise furnished by Section 117(f). The court, in holding that the gain realized was ordinary income, distinguished the *Caulkins* decision. It reasoned that the *Caulkins* rule was limited to situations in which there was an actual retirement under Section 117(f). Having distinguished the *Caulkins* case, the court cited *Hort, Horst, Fisher* and *Rhodes' Estate* to support their finding of ordinary income. As previously noted it is felt that Section 117(f) merely characterizes certain retirements as sales or exchanges. Once this principle is accepted a conflict between the *Caulkins* case and the *Paine* case becomes apparent.

The reasoning and conclusion of the *Paine* case seems to represent the correct view. Where a taxpayer makes a bona fide sale of a discount bond before maturity the gain attributable to the discount should be ordinary income.

Conclusion

1) Where a non-coupon, non-registered bond is redeemed by the corporation the gain realized by the holder is ordinary income.

2) A conflict arises when a coupon or registered bond is redeemed by the corporation. The Tax Court and the Sixth Circuit have held that the gain realized is capital gain,[45] while the Internal Revenue Service takes

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43. See note 38 *supra*.
44. See note 39 *supra*.
45. Commissioner v. Caulkins, 1 T.C. 656 (1943) *aff'd* 144 F.2d 482 (6th Cir. 1944).

the position that the gain is ordinary income.[46] An audit of an income tax return in which such a gain has been treated by the taxpayer as capital gain will be certain to result in litigation if the taxpayer persists in his contention.

Although the outcome of any litigation cannot be predicted with absolute certainty, the reasoning and argument previously propounded, herein, indicates a definite probability that the remaining circuits will not follow the Sixth Circuit. The Tax Court, itself, faced with a similar factual situation may well reverse its previous holding.

3) Where there is a sale of a discount bond prior to maturity, the realized gain attributable to the original discount is ordinary income. This conclusion was reached by the Tax Court in the *Paine* decision.[47] This case is now pending before the Eighth Circuit and should result in an affirmation of the Tax Court's determination.

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46. REV. RUL. 55-136, 1955 INT. REV. BULL. No. 11, at 12.
47. See note 39 *supra*.