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Stanley H. Spieler

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COMMENTS

FAVORED TAX TREATMENT OF CORPORATE DISCOUNT BONDS UNDER SECTION 117 (f) OF THE INTERNAL REVENUE CODE

New vistas of bond financing have been opened, perhaps inadvertently, by reason of Section 117 (f) of the Internal Revenue Code as it pertains to increment from corporate discount bonds.¹ It may well be that the type of bond which will play the most predominant role in corporate borrowing, in the absence of remedial legislation, is the one which will be issued purposely at a discount, paying no interest as such during the life of the loan but instead increasing in redemption price until the face amount is reached, *e.g.*, similar in plan and operation to United States Government bonds, Series E. The potentialities of this form of security rest in the continuance of the present policy of classifying increment from corporate discount bonds as *capital gains* rather than *income*, and, therefore, subject to a lower rate of taxation.

The applicability of Section 117 (f) to increasing redemption price bonds has been decided only once.² Investor's Syndicate issued an "Accumulative Installment Certificate," bearing the notation "5½%," which called for the annual payment of a stipulated sum by the certificate holder for a period of ten years. The total amount paid in over the ten-year period was \$15,043.33 and the redemption price was \$20,000, the increase representing 5½% cumulative interest on the amounts annually paid in. The court arrived at the conclusion that although there was no logical reason for the increment on such a bond not to be subject to taxation on the same basis as interest from other types of securities,³ the "installment certificate," nevertheless, was within the express provisions of Section 117 (f) and subject only to a capital gains tax. The opinion contained strong language:

"... the transaction presents no true aspect of capital gain. . . . Congress might well have made the differentiation urged by the Commissioner, since it is difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income. . . . Unfortunately for the Commissioner's contention, Congress has not made the differentiation . . .

1. "... amounts 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." INT. REV. COD. 117 (f) (1940).

2. Commissioner of Internal Revenue v. Caulkins, 144 F. 2d 482 (C. C. A. 6th 1944), *affirming* 1 T. C. 656 (1943).

3. INT. REV. CODE § 22(a), as amended, 53 STAT. 574, 575 (1939), 26 U. S. C. A. § 22 (a) (1940) reads: "Gross income includes gains, profits, and income derived from . . . interest . . . securities. . . ."

inconsistencies and inequalities may well result from the application of Section 117 (f). If this is so, the correction of this defect in the operation of the statute is for Congress and not for the courts." ^{3a}

In the past, the concept of the discount bond has been limited in that it was merely a means to utilize the psychological factor of an illusory bargain (bonds are issued bearing a lower than prevailing rate of interest, the issuer knowing that they will be sold at a discount),⁴ or, as a last resort, to raise money when the face value of the bonds could not be obtained from the lending public due to depressed financial conditions, either in the particular industry or in the market in general. However, these discount bonds have been regular in the sense that interest was to be paid and they had no sliding scales of redemption price. Additional reasons for the failure of corporations to have issued non-interest bearing appreciation bonds in the past may well have been the prevalence of cash in the bond market since the holding in the *Caulkins* case⁵ and the novelty of this type of bond financing by private companies.

To be considered in the estimation of the practical possibilities of the proposed discount bond as a medium of corporate borrowing are, the attraction of lower tax rates to investors in high income brackets; the advantage to the issuing corporation of being able to pay a lower than prevailing rate of interest and still successfully compete in the market; the tax advantage of corporate discount bonds over United States Government discount bonds; and the popularization of discount bonds in the past few years.

Corporate discount bonds offer an excellent opportunity for the private investor in a high income bracket. The maximum rate of taxation on income is 85½ per cent, while that on a long-term capital gain is 25 per cent. For an investor in the 60 per cent federal income tax bracket a \$750 four per cent bond will net \$120, after taxation, at the end of ten years. A non-interest bearing appreciation bond issued at \$750, redeemable at \$1000 (2.9 per cent "interest" over a ten-year period), and maturing in ten years, will net the investor \$187.50. It should be noted, however, that in the case of the ordinary corporation bond the investor has the use of the interest *during* the life of the bond. In the example just cited an annual reinvestment of the interest in the same type security would net additionally for the investor, after taxation, approximately \$9.00, thereby reducing the actual difference of gain, after taxation, between the two types of bonds.

As may be seen from the just cited illustration, it is a corollary that a company might appeal to large investors although paying a considerably lower rate of interest than that of companies issuing competing but regular type

3a. See Commissioner of Internal Revenue v. *Caulkins*, *supra* at 484.

4. 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 664 (4th ed. 1941).

5. See *The Wall Street Journal*, Nov. 23, 1948, p. 4, col. 3, showing adequate supply of cash available for corporate borrowing since V-J Day.

bonds. To compute the actual savings to the corporation, however, it is important to note that the difference in interest paid on the two types of bonds does not represent the true savings. Interest is an allowable deduction for the issuing corporation. The formula for savings is: Difference of interest paid multiplied by, one hundred per cent minus corporate tax rate.

An additional circumstance favoring corporate discount bond success is the statutory provision subjecting United States Government bonds to federal income tax.⁶ This, in effect, would shift the tax load onto the Government discount bond investor while relieving the corporate discount bondholder of his proportional share of the taxes. Of all the features of the corporate discount bond, this is the one most likely to produce corrective legislation. Such legislation might either place Government discount bonds in the capital gains class⁷ or remove the corporate discount bonds from that category. The former possibility would not totally eliminate the previously mentioned advantageous features of the corporate discount bond, for it still could compete favorably with the Government discount bond by paying a higher rate of "interest" than the latter, but one, nevertheless, lower than that being currently paid by corporations. The latter alternative would, of course, destroy the most attractive selling point of the corporate discount bond.

Non-interest bearing appreciation bonds would undoubtedly give rise to a number of tax problems. By reason of a series of cases⁸ and tax regulations⁹ it is possible to speculate that the original amount of discount will be considered as a deduction pro-ratable over the life of the bond when books are kept on an accrual basis. In effect, a corporation issuing a \$1000 bond discounted at \$750 might deduct \$25.00 a year. This in turn would reduce the amount of interest the corporation itself is actually paying, since part of it is deductible. The novel conclusion is then reached that, in effect, the Government has been burdened with the payment of the interest on a corporate bond.¹⁰

The previously discussed advantages of corporate discount bonds might be offset by redemption before maturity, a privilege ordinarily a feature of increasing redemption price bonds. It has been held consistently that when a corporation buys back its own bonds at a discount, the amount of discount (difference between redemption price and maturity price) is subject to taxa-

6. 49 STAT. 21 (1917), as amended, 31 U. S. C. 757 (d) (Supp. 1948).

7. H. R. 6999, 80th Cong., 2d Sess. (1948). This bill, which would place United States Government discount bonds in the capital gains class, was introduced by Rep. Hardie Scott of Pennsylvania, but went no further than the committee stage.

8. Chicago, Rock Island & Pacific Ry. Co. v. Commissioner of Internal Revenue, 13 B. T. A. 988 (1928), *aff'd* (without discussion on this point), 47 F. 2d 990 (C. C. A. 7th 1931); Lincoln Mortgage & Title Guaranty v. Commissioner of Internal Revenue, 296 U. S. 654 (1936), *affirming* 79 F. 2d 585 (C. C. A. 3d 1935).

9. 26 CODE FED. REGS. § 29.22(a)-17(c) (1) (Cum. Supp. 1943).

10. The conclusion of the cases cited in note 8 *supra*, that pro-ration of discount is allowable, is based on the theory of additional interest to be paid. *Query*: Would courts apply the rule as announced by the above cases or regulations where no interest as such is to be paid?

tion at regular federal corporation income tax rates.¹¹ The formula to determine whether there has been a repurchase at a discount is: if the corporation buys back its own bonds at a price less than the issue price plus any deductions already made (or at the face value minus any amount of discount not yet deducted), then there has been a purchase at a discount.¹² It will be noticed that the redemption price of a bond does not increase arithmetically but on a curve, while the pro-ration of discount is constant. Therefore, at a point where the increment in the redemption price has not equaled the deductions already made (this condition exists for the greater part of the life of a discount bond), if the company redeems, it will net a gain for the year subject to taxation.¹³

Finally, it should be taken into consideration that the increasing redemption price bond is no longer a novelty to the investing public due to the extensive and persistent advertising efforts of the Government in connection with its own discount bonds during the past war.

From evidence of public interest¹⁴ it is quite likely that private corporations will place appreciating non-interest bearing discount bonds on the market in the near future. They should be almost certain to sell well and, incidentally, create a number of difficult tax and legislative problems.

STANLEY H. SPIELER

11. *United States v. Kirby Lumber Co.*, 284 U. S. 1 (1931). See Note, 112 A. L. R. 186, 200 (1938).

12. 26 CODE FED. REGS. § 29.22(a)-17(c) (3) (Cum. Supp. 1943).

13. INT. REV. CODE § 22(b) (9), 26 U. S. C. A. § 22(b) (9) (Supp. 1947)) has relieved corporations of tax liability on repurchase at discount through the year 1949. In order to obtain the benefits of this section the corporation must observe the requirements of INT. REV. CODE § 113(b) (3), 26 U. S. C. A. § 113(b) (3) (1945), which provides for reduction of basis of corporate property serving as security for the bonds by the amount of the discount. This provision, in effect, totally relieves the corporation of any tax liability unless property is sold, and even then the amount of discount (if profit is realized) is taxable only as a capital gain rather than as income. 1 P-H FED. TAX SERV. ¶ 8851-8853 (1948).

14. See *The Wall Street Journal*, Oct. 20, 1948, p. 1, col. 5; 5 P-H FED. TAX SERV. ¶ 70, 567 (1948).