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Here, again, there is a corresponding problem for the buyer. When an asset is sold and the seller gets an employment contract as part of the sale, the Government may claim that the alleged payment for services is part of the purchase price of the asset, and not deductible by the buyer. Again, the terms of the contract and the obligations of the seller to perform services and/or not to compete should be the important factors.

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CAPITAL GAIN PROBLEMS IN PARTICULAR AREAS (cont'd) DISPOSITIONS OF EVIDENCES OF INDEBTEDNESS

E. Robert Hellawell

The determination of whether long term capital gain treatment will be received on the disposition of evidences of indebtedness is governed by the same general rules applicable in other areas, *i.e.,* the evidence of indebtedness must be a capital asset,[1] must be held for more than six months and must be disposed of in a sale or exchange.

The sale or exchange requirement poses a problem in this area as it is now well settled that, in the absence of statute, retirement of a debt obligation will not qualify as a sale or exchange.[2] A very substantial measure of relief, however, is provided by section 1232(a)(1) which treats amounts received on the retirement of certain obligations as amounts received in an exchange.[3] That section applies only to obliga-

1. INT. REV. CODE OF 1954, § 1221 (Hereinafter cited as §) provides two special cases of debt obligations which will not qualify as capital assets: § 1221(4) — "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1)," *i.e.,* inventory; § 1221(5) — United States Obligations "issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue." As to the general requirements of a capital asset see discussion pp. 256-66.

2. Fairbanks v. United States, 306 U.S. 436 (1939); John H. Watson, Jr., 27 B.T.A. 463 (1932). Prior to the *Watson* case, a retirement had been held to qualify as a sale or exchange. See Henry P. Werner, 15 B.T.A. 482 (1929).

3. As to the meaning of the term "retirement," see Howard Carleton Avery, 13 T.C. 351 (1949) (certain payments on Cemetery Association certificates held made in retirement); Edith K. Timken, 6 T.C. 483 (1946) (partial payments on "creditors notes" held partial retirement). On a sale to obligor, *compare* Lee v. Commissioner, 119 F.2d 946 (7th Cir. 1941), *affirming* 42 B.T.A. 920 (1940), *with* Warner A. Shattuck, 25 T.C. 416 (1955). Surrender of obligations for less than their face value to the issuing corporation has been held to be a retirement. McClain v. Commissioner, 311 U.S. 527 (1941) (indicating that the word "retirement" is broader than and includes the word "redemption"); *accord,* Shaw v. Commissioner, 117 F.2d 587 (7th Cir. 1941); William H. Noll, 43 B.T.A. 496 (1941); Truman H. Newbury, 4 CCH Tax Ct. Mem. 576 (1945). The Internal Revenue Service has ruled that "the purchase or refunding by a corporation of its bonds prior to their maturity date, with the intention of not reissuing the same bonds, amounts to 'retirement' of those bonds within the meaning of

tions which are capital assets and which are issued by a corporation, a government or a political subdivision thereof. Within this category the section applies broadly to obligations which are *issued* after December 31, 1954. The specific types of obligations listed as qualifying are: "bonds, debentures, notes, or certificates or other evidences of indebtedness." Although the term "evidence of indebtedness" has not yet been fully defined by case law, it seems broad enough to cover all usual types of corporate debt obligations.[4] Perhaps the only type of obligations on which there may be some question is the open account where there is no evidence of the debt except in entries on the books of the debtor and creditor and the promise to pay embodied in a contract but not otherwise evidenced by a separate paper. In keeping with the broad scope of section 1232(a)(1), however, even these obligations should be considered to qualify. As to obligations issued prior to January 1, 1955 the requirements are considerably more strict. Section 1232(a)(1) applies only to bonds or other evidences of indebtedness issued with interest coupons or in registered form (or to those in such form on March 1, 1954).

Although section 1232(a)(1) covers a large number of obligations, many other obligations remain subject to the rule that a retirement is not treated as a sale or exchange. Such obligations include all those on which an individual is the obligor. They are often received under circumstances such as a corporate liquidation where establishing a low value will reduce an immediate capital gain tax. But, it should be remembered that where a low valuation results in a low basis on the obligation the difference between the valuation which is used and the face amount will be taxable as ordinary income upon retirement of the obligation. The holder of low basis obligations not qualifying under section 1232(a)(1) may be able to avoid ordinary income by disposing of the obligations in a sale or exchange prior to the time of retirement.[5]

DISCOUNT TYPE OBLIGATIONS

If the market rate of interest for a particular debtor on ten year money is five per cent and if that debtor issues ten year obligations with an in-

§ 117(f)." I.T. 2986, XV-1 CUM. BULL. 136 (1936). See discussion p. 362 for authorities on receipt of defaulted interest.

4. Its meaning has been considered by several authorities under § 117(f) of the Internal Revenue Code of 1939, ch. 1, 53 Stat. 52. Held to be evidences of indebtedness: Rieger v. Commissioner, 139 F.2d 618 (6th Cir. 1943) (certificates of claim against an insolvent bank); Adolf Klein, 15 T.C. 26 (1959) (mortgage certificates); Norman Buckner, 43 B.T.A. 958 (1941) (receiver's certificate of proof of claim). Held not to be evidences of indebtedness: Avery v. Commissioner, 111 F.2d 19 (9th Cir. 1940) (endowment contract); Chapin v. McGowan, 58-1 U.S. Tax Cas. ¶ 9469 (W.D.N.Y. 1958) (endowment policies); Adolph Klein, 15 T.C. 26 (1959) (mortgage participations); Frank J. Cobbs, 39 B.T.A. 642 (1939) (combined life insurance and annuity contract); Frank Hawkins, 3 CCH Tax Ct. Mem. 1135 (1944) (insurance and annuity contracts).

5. See discussion pp. 271-72.

terest rate of two per cent on the principal amount it is obvious that the bonds will initially sell for less than par, the amount to be repaid at maturity. It is almost as clear that the spread between the issue price and the amount to be repaid at maturity is essentially an amount which compensates the bond buyer (the lender) for receiving less than a fair interest rate during the life of bonds. As such, the spread is a substitute for ordinary income interest. Assuming a steady bond market the price of such bonds will gradually rise as the maturity date approaches allowing a holder to sell at any time and realize a profit about equal to the difference between the normal interest rate and the low rate on such bonds. Yet the debtor's two per cent bonds may be capital assets in the hands of their owners. Consequently, if they are held for more than six months and then disposed of in a sale or exchange, or a redemption which qualifies as a sale or exchange, the owner has fulfilled the normal requirements for taxation of the gain at a capital gain rate. Unfortunately for taxpayers, the conversion of interest income into capital gain is not that simple. The prime obstacle today is section 1232(a)(2).

That section, like most Code provisions designed to prevent the conversion of ordinary income into capital gain, has a substantial background which is of considerable importance today.[6] As indicated above, the retirement of a debt obligation, in the absence of special statutory provision, is not considered to be a sale or exchange. With this rule in mind, Congress in 1934 enacted section 117(f), the predecessor of section 1232 (a)(1). That section provided that amounts received upon retirement of certain corporate obligations "shall be considered amounts received in exchange therefor."[7]

The first case squarely considering the discount issue did so under the provisions of section 117(f). *George Peck Caulkins*[8] concerned the retirement of an "Accumulative Installment Certificate." The certificate provided for annual payments for a period of ten years. At that time the certificate would mature and the holder would receive an amount greater than the total of his annual payments — an amount equivalent to interest on the purchase price of the certificate computed at the rate of five and one-half per cent per year. The certificate was held to qualify under

6. See Garian, *Transactions in Bonds*, N.Y.U. 18TH INST. ON FED. TAX 393 (1960); Janin, *The Israeli Bond Ruling: Legislation by Administrative Fiat?*, 33 TAXES 191 (1955); Kaitz, *Eulogy on Discount Bonds*, 32 TAXES 814 (1954); Kaitz, *Tax Advantages of Discount Bonds in Corporate Financing*, 32 TAXES 453 (1954); Zafft, *Discount Bonds — Ordinary Income or Capital Gain?*, 11 TAX L. REV. 51 (1955).

7. Section 117(f) of the Internal Revenue Code of 1939, ch. 1, 53 Stat. 52, provided: "Amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidence of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor."

8. 1 T.C. 656 (1943), *aff'd*, 144 F.2d 482 (6th Cir. 1944).

section 117(f) and the Tax Court held that the gain on retirement qualified as capital gain under the mandate of that section. The Sixth Circuit, in affirming the Tax Court, recognized the validity of the Commissioner's point that the gain was in the nature of interest, but rested on its belief that by enacting section 117(f) Congress had shown its intention not to tax such gain as ordinary income. After losing the appeal, the Internal Revenue Service acquiesced in the *Caulkins* decision and the acquiescence remained in force until withdrawn in 1955.[9]

Commissioner v. J. I. Morgan,[10] decided in 1959, involved an almost identical type of debt obligation as that of the *Caulkins* case and is in direct opposition to that case. While agreeing that section 117(f) applied to the obligation, the Ninth Circuit stated that its provisions did not require capital gain treatment for ordinary income items. It reasoned that the sole purpose of section 117(f) was to put a retirement on the same footing as a sale or exchange, that gain on the certificate was in the nature of interest and, consequently, that gain was an ordinary income item.

The *Caulkins* and *Morgan* cases are squarely opposed only on the proper interpretation of section 117(f). Because of the Sixth Circuit's strong reliance on section 117(f) it does not follow from the *Caulkins* case that it would allow the interest element in a discount obligation to receive capital gain treatment on a sale or exchange. Several cases have distinguished the *Caulkins* case in sales or exchange situations on this ground.[11] On the other hand, it does follow from the *Morgan* case that the Ninth Circuit would tax the interest element as ordinary income on a sale or exchange as well as on a retirement. The court had no difficulty deciding a case governed by the language of section 117(f) and there is nothing in the opinion to indicate that a retirement is subject to special treatment.

There is something to be said for the reasoning of both the *Caulkins* and *Morgan* cases. The language of section 117(f) states that amounts received upon the retirement of qualifying obligations shall be considered as amounts received in exchange therefor. Such language can be read,

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9. Nonacquiescence in the Tax Court decision was initially published in 1943-1 CUM. BULL. 23. After the appeal, notice of nonacquiescence was withdrawn and acquiescence was published in 1944-1 CUM. BULL. 5. In 1953 acquiescence was limited to the particular facts of the *Caulkins* case. Rev. Rul. 53-119, 1953-2 CUM. BULL. 95. In 1955 nonacquiescence was announced in 1955-1 CUM. BULL. 7. See Rev. Rul. 56-299, 1956-1 CUM. BULL. 603, superseding and republishing Rev. Rul. 55-136, 1955-1 CUM. BULL. 213. Nonacquiescence was not applied retroactively to "Accumulative Installment Certificates" purchased during the period in which acquiescence was in effect.

10. 272 F.2d 936 (9th Cir. 1959), *reversing* 30 T.C. 881 (1958), which in a short opinion had simply followed the *Caulkins* case.

11. L. Lee Stanton, 34 T.C. No. 1 (April 7, 1960); F. Rodney Paine, 23 T.C. 391 (1954), *rev'd on other grounds*, 236 F.2d 398 (8th Cir. 1956); *cf.* Warner A. Shattuck, 25 T.C. 416 (1955).

as in the *Caulkins* case, to mean that all amounts received are treated as an exchange for the capital asset obligation and, consequently, must receive capital gain treatment. But the language is not so clear as to compel this result with regard to amounts received because of an ordinary income element adhering to the obligation. Nor does the legislative history of section 117(f) compel this result. That history is, in fact, particularly unenlightening. The Committee Reports on the 1934 Revenue Act do not deal with section 117(f). The background of the statute, however, does indicate a concern with securing treatment of a retirement as a sale or exchange and a desire to change the result of cases holding gain on retirement to be ordinary income because of the absence of a sale or exchange.[12] To this extent section 117(f) appears designed to put a retirement of the specified type of debt obligation on the same footing as a sale or exchange. The *Caulkins* case, in relying on the specific language of section 117(f) to tax the discount element at capital gain rates, results in favoring a redemption over a sale or exchange. There is little reason to believe that this was the intention of section 117(f).

While the *Caulkins* result could be reached apart from the language of section 117(f), no case since *Caulkins* has done so in a clear discount situation where the point was considered.[13] In the *Caulkins* type situation the gain on retirement seems clearly a substitute for interest. Since the *Caulkins* decision, the tide in other areas of the tax law has been running against the *Caulkins* type of result with cases finding ordinary income upon what appears to be the sale or exchange of a capital asset.[14] But while the tide seems to be against the *Caulkins* case its complete demise cannot safely be predicted. The only case flatly opposing it is *Morgan*,[15] while several lower court cases follow it.[16]

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12. See the discussion and material quoted in Commissioner v. Morgan, 272 F.2d 936 (9th Cir. 1959). The court in the *Morgan* case believed it was plain that § 117(f) was designed *only* to put a retirement in the same position as a sale or exchange. However, some of the cases prior to the enactment of § 117(f) which Congress had in mind involved discount situations. See, *e.g.*, Henry P. Werner, 15 B.T.A. 482 (1929). This might suggest that the broad language of § 117(f) was intended to result in taxation of the discount as capital gain. Some courts after the enactment of § 117(f), although not discussing the discount issue, use language indicating such a belief. See, *e.g.*, William H. Noll, 43 B.T.A. 496, 501 (1941). "Congress . . . intended to take out of the ordinary income provisions of the Revenue Act gain realized by a taxpayer upon the retirement of bonds." *But see* G.C.M. 21890, 1940-1 CUM. BULL. 85. On the other hand, there is no indication in the legislative history of § 117(f) that Congress considered the discount issue, and the early cases did not discuss it.

13. *But cf.* Paine v. Commissioner, 236 F.d 398 (8th Cir. 1936), *reversing* 23 T.C. 391 (1954). The case is discussed at pp. 359-60. See also Edith K. Timken, 6 T.C. 483 (1946), in which the issue was not discussed.

14. See generally, discussion pp. 256-66.

15. Also directly opposed is Rev. Rul. 56-299, 1956-1 CUM. BULL. 603, *republishing* Rev. Rul. 55-136, 1955-1 CUM. BULL. 213.

16. Addison O. Wood v. United States, 1960 Stand. Fed. Tax Rep. (60-2 U.S. Tax Cas.) ¶ 9798 (W.D. La. Nov. 15, 1960); Rosen v. United States, CCH 1961 STAND. FED. TAX REP.

Section 1232(a)(2), which deals with the discount situation, legislatively overrules the *Caulkins* case, but it applies only to obligations *issued* after December 31, 1954. Thus the *Caulkins* and *Morgan* cases are and will continue to be of significance so long as earlier issued obligations are outstanding. Section 1232(a)(1), however, rather than section 117(f) applies to retirement of qualified obligations occurring since 1954. Although the relevant language of section 1232(a)(1) is almost identical with that of section 117(f), it will probably be more difficult to persuade a court that section 1232(a)(1) is specially designed to allow capital gain treatment upon the retirement of discount type obligations.[17] Accordingly, some of the force of the *Caulkins* case may not be applicable to recent and future redemptions. The net result of this is, of course, uncertainty.[18] There is still a chance to secure capital gain on the discount element of debt obligations issued prior to January 1, 1955 but the road to such treatment is difficult.

SECTION 1232(a)(2)

Such is the background of section 1232(a)(2). Essentially, that section provides that gain on the sale, exchange or retirement of discount type bonds will be taxed as gain from the sale or exchange of property which is not a capital asset (that is, as ordinary income) to the extent that the gain is compensation for a low rate of interest.[19]

The best way to describe the mechanics of section 1232(a)(2) is to trace through an example:

Boomer Corporation decides to finance an expansion program by the issuance of $1,000,000 of fifteen year debentures. Market conditions are

(60-1 U.S. Tax Cas.) ¶ 9374 (W.D. Pa. March 25, 1960); Ely D. Goodstein, 30 T.C. 1178 (1958) (The Commissioner did not appeal on the discount issue. See Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959)); Steven W. Kormendy, 18 CCH Tax Ct. Mem. 353 (1959). See also J. I. Morgan, 30 T.C. 881 (1958), *rev'd*, 272 F.2d 936 (9th Cir. 1959).

17. *But see* Addison O. Wood v. United States, 1960 Stand. Fed. Tax Rep. (60-2 U.S. Tax Cas.) ¶9798 (W.D. La. Nov. 15, 1960); Rosen v. United States, CCH 1961 STAND. FED. TAX REP. (60-1 U.S. Tax Cas.) ¶ 9374 (W.D. Pa. March 25, 1960), which adopted the Caulkins rule in a retirement governed by the provisions of § 1232(a)(1).

18. In commenting on the state of pre-existing law in this area the Senate and the House Reports concerning the 1954 Code disagree: *Compare* H.R. REP. NO. 1337, 83d Cong., 2d Sess. 83 (1954) (indicating that gain realized on discount bonds is taxed as capital gain even though it represents a form of interest) *with* S. REP. NO. 1622, 83d Cong., 2d Sess. 112 (1954), indicating that there is uncertainty as to the treatment of gain on the retirement of a discount bond and comparing the position of the Service with the *Caulkins* case.

19. Section 1232 applies only to bonds or other evidences of indebtedness *issued* after December 31, 1954. Excepted are obligations qualifying for tax exemption under § 103. The Service position on such obligations is that a discount on the original issuance is the equivalent of interest. Accordingly, although gain on disposition of tax exempt obligations is normally taxable, gain attributable to the discount is considered non-taxable. G.C.M. 10452, XI-1 CUM. BULL. 18 (1932); I.T. 2629, XI-1 CUM. BULL. 20 (1932). See also Rev. Rul. 60-210, 1960 INT. REV. BULL. NO. 22, at 10; Rev. Rul. 57-49, 1957-1 CUM. BULL. 62 (treatment applies only to discount on original issuance).

such that the Boomer debentures would have to bear an interest rate of six and one-half per cent to sell at par. Nevertheless, Boomer decides after consultation with its bankers to have the debentures carry an interest rate of only four per cent and to offer to sell them to the public at a price of $800 per $1,000 face amount debenture. The $1,000,000 face value of debentures are successfully marketed.

Mr. Smith purchases one of the Boomer debentures for $800. If he holds the debenture until maturity and then collects $1,000 he will have $200 of ordinary income. This result is reached because section 1232 provides for taxing the amount of "original issue discount" as ordinary income where the evidence of indebtedness is held to maturity and paid in full. The "original issue discount" is defined in section 1232(b)(1) as the difference between the issue price[20] and the stated redemption price at maturity.[21]

There is one exception to this treatment, falling in the *de minimis* category: if the original issue discount is less than one-fourth of one per cent of the redemption price at maturity multiplied by the number of complete years[22] to maturity then the original issue discount shall be considered to be zero. Thus, if the Boomer debentures had borne a higher rate of interest and had been sold at $962.51, Mr. Smith would have had a gain of $37.49 taxable as a capital gain.[23]

If, instead of holding the Boomer debenture until maturity, Mr. Smith sells it for $900 after holding it for exactly five years there are two possible ways he may be taxed. Which will be employed depends on whether Boomer Corporation intended at the time of issuance to call the debenture before maturity. If at the time of issuance there was no intention to call the debentures before maturity then Mr. Smith will realize as ordinary income "an amount which bears the same ratio to the orig-

20. Where evidences of indebtedness are registered and sold to the public, the "issue price" is the initial offering price to the public at which price a substantial amount of such debt is sold — not the price paid by the underwriters. With privately placed obligations the "issue price" of each obligation is the price paid by the first buyer of such obligation.

21. Note that ordinary income treatment is provided only for obligations originally issued at a discount. If an obligation is initially sold at par (100), § 1232 (a) (2) will not apply to it. If, following issuance, the market rate of interest rises and a purchaser buys the obligation at 90, that purchaser will not have ordinary income upon later retirement of the bond at 100. Thus by purchasing such obligations capital gain treatment can be secured for income which is the equivalent of interest. On the other hand bonds received in a recapitalization in exchange for bonds originally issued at a discount are also considered discount bonds. Rev. Rul. 60-37, 1960 INT. REV. BULL. NO. 5, at 29.

22. Note that only complete years count. Thus, a four and one-half year debenture must bear less than a 1% discount (not less than a 1⅛% discount) to come within the *de minimis* provision.

23. .25% x 15 (number of complete years until maturity) equals 3¾%. 3¾% x $1,000 equals $37.50. For the *de minimis* provision to apply, however, the discount must be *less than* one-fourth of 1% per year. Thus, in the example, Boomer Corporation sold the debentures for $962.51.

inal issue discount . . . as the number of complete months that the . . . evidence 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." In the above example, Mr. Smith held the Boomer debenture five years or sixty months out of a fifteen year or 180 month term. Thus, Mr. Smith would have ordinary income equal to one-third of the original issue discount or $66.66. The balance of his gain, amounting to $33.34, would be taxable as capital gain. If the amount of his gain was $66.66 or less it would all be taxable as ordinary income. Section 1232 applies only to gains and, consequently, if Mr. Smith had a loss on the sale he would receive capital loss treatment.

The pattern of our federal income tax is such that compensation for the use of money (interest) is taxed as ordinary income; but appreciation in the value of a debt obligation, either because the debtor's credit position has improved or because general interest rates have decreased, is ordinarily taxed as capital gain. The proration formula under section 1232, illustrated above, fits into this pattern.[24] Presumably, the value of a discount type obligation, other factors remaining equal, will rise in approximately equal annual amounts as maturity approaches. The annual rise should approximate the difference between the interest rate of the obligation (based on issuance price) and a fair interest rate for similar obligations.[25] There is ample justification for taxing such rise as ordinary income.[26] But if the market value of the obligation goes up even more because of market conditions or an improvement in the debtor's credit, there is normally no reason to tax such increment any differently than a rise in value of other non-discount obligations.

The proration formula applies, however, only if at the time of issuance of the debentures there was no intention to call them before maturity. If such was not the case, then the statute provides that all of Mr. Smith's gain up to the full amount of the original issue discount will

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24. Under some circumstances the formula can result in some advantage to the holder as compared with the holder of a non-discount bond. For example, *A* buys a 10 year 3% bond at 90 at the time of original issuance in 1955. *A* holds the bond for 5 years and because of deterioration in the bond market can sell only for 90. *A* has no gain, no loss, and $15 of ordinary income because of interest during the 5 years he held the bond. The buyer of a bond for 100 in 1955 which paid a normal (assume 4%) rate of interest would receive quite different treatment. On a sale 5 years later he would have a capital loss of approximately $5 and would have had $20 of ordinary income.

25. Actually the rise should be somewhat greater. The total discount must reflect not only the price paid for use of principal but also the price for the failure to pay all or part of the interest until maturity.

26. Note, however, that § 1232(a)(2) results in bunching the income in the year of disposition. Avoidance of bunching is at least one rationalization of capital gain treatment. Special relief from the bunching effect is provided for *Caulkins* type of obligations. §§ 1232(d), 72(c) (three year spreading). Section 454(a) also provides relief for certain non-interest bearing obligations. See § 1232(a)(2)(c).

be taxed as ordinary income. Only gain in excess of the entire original issue discount can be taxed as capital gain.

The intention to redeem provision was added to section 1232 by the Technical Amendments Act of 1958.[27] As passed by the House of Representatives, gain up to the full amount of "original issue discount" was taxed as ordinary income under all circumstances.[28] The Report of the House Committee on Ways and Means stated that "a practice has developed . . . of issuing bonds with an artificially large discount and then redeeming them at par or at a call price before their maturity date."[29] In such instances, under the proration formula, only a portion of the gain would be taxed at ordinary income rates and the balance would be capital gain. Such a technique could avoid section 1232 and secure capital gain treatment for gain which was in the nature of interest.[30]

But avoidance would be present only with some kind of collusion between the buyer and the issuing corporation as to early redemption. In the normal case self-interest would dictate that the issuing corporation leave outstanding its low interest discount obligations as long as possible. If the market rate of interest should fall below the rate paid on discount obligations then, of course, the issuer would be likely to redeem. But in that event, the gain over the amount taxed as ordinary income by the proration formula would be attributable to a fall in the market rate of interest and would be appropriately taxed as capital gain.

In recognition of the harshness of the rule of the House Bill the Senate passed the amendment to section 1232 which was finally adopted, allowing use of the pro-ration formula when at the time of original issuance there was no intention to call the obligation before maturity. The report of the Senate Committee on Finance indicates understanding that the bill would result in taxation as ordinary income of the full original issue discount only where there was collusion between the issuer and the buyer.[31] The flavor of the Treasury Regulations, adopted under section 1232, is less favorable to taxpayers although there is some indication of

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27. 72 Stat. 1606, § 50 (a) (1958).

28. H.R. 8381, 85th Cong., 1st Sess. (1958).

29. H.R. REP. NO. 775, 85th Cong., 1st Sess. 30 (1957); See also *id.* at 87.

30. For example, *X* corporation sells non-interest bearing notes with a face value of 100 to mature in 5 years. The normal interest rate for such notes would be 5% per annum. Such notes might have a market price of approximately 80 — allowing a gain of 20 or 25% on the price over 5 years. However, *X* corporation lets it be understood that it will redeem the notes at face in 2 years. Consequently, it is able to sell them at something over 90. Upon redemption 2 years later the buyer realizes a gain of something under 10 or an amount roughly equal to the market interest rate of 5% per annum. Under the proration formula, however, only 40% of his gain is taxed as ordinary income.

31. S. REP. NO. 1983, 85th Cong., 1st Sess. 204-05 (1958). "The taxpayer acting in good faith should have little difficulty in showing facts which adequately negative the possibility of collusion. . . ."

a primary concern with the collusive situation.[32] It would be unfortunate if amended section 1232 were applied to tax as ordinary income the full amount of the original issue discount in non-collusive situations where the rise in market value over the amount of the proration formula was attributable to a general market rise or an improvement in the debtor's credit.

In some situations the new rule, where an intention not to redeem cannot be shown, may work an unusual result. Section 1232 operates to tax all or a portion of the gain of a subsequent buyer in the same manner as that of the initial buyer.[33] In the example given earlier, Mr. Smith sold a fifteen year Boomer debenture which had been outstanding five years for $900 — a $100 gain. If Mr. Jones bought that debenture from Mr. Smith, held it for five years and sold it for $975, $66.66 would be taxed as ordinary income under the proration formula. The balance of Mr. Jones' gain would be taxed as capital gain. However, if it could not be proven that at the time of original issuance Boomer Corporation had no intention to redeem the debentures before maturity, all of Mr. Jones' gain would be taxed as ordinary income (since it is not greater than the $200 of "original issue discount" on such debentures). In some unusual circumstances this rule could result in far more than the full amount of the original issue discount being taxed as ordinary income.[34]

ISSUANCE OF OBLIGATIONS FOR PROPERTY OTHER THAN CASH

Section 1232 and the Regulations thereunder offer no guidance as to when a debt obligation issued for property other than cash will be considered a discount obligation and, in such a case, how the amount of original issue discount is to be determined. On the surface it might appear that an acquisition of a debt obligation for property other than cash differs in no substantial regard from an acquisition for cash and should be treated the same. The property other than cash situation, however, has its own peculiar problems.

F. Rodney Paine,[35] presented the property other than cash situation. In 1917, Oliver, a corporation, issued its non-interest bearing notes to Niles, a corporation, in exchange for iron ore land. Niles liquidated and a portion of the notes went into a trust of which the taxpayer was beneficiary. The taxpayer's notes matured serially, one every six months

32. Treas. Reg. § 1.1232-3(b)(4). (Hereinafter cited as Reg.).

33. Excepted are persons who purchase the obligation at a premium. § 1232(a)(2)(B)(ii).

34. For example, *A* buys a 10 year bond at time of original issuance at 90. He holds it 2 years, sells at 95 to *B* and realizes 5 of ordinary income if he cannot prove non-intention to redeem. *B* holds the bond a year, during which time the market falls, and sells to *C* at 90. *C* holds 2 years, during which time the market rises, and sells at 99 to *D*. He has 9 of ordinary income if he cannot prove non-intention to redeem.

35. 23 T.C. 391 (1954), *rev'd*, 236 F.2d 398 (8th Cir. 1956).

through 1952. The case involved the sale of some notes shortly before their maturity in the late 1940's. There was a gain on the sale because upon the liquidation of Niles the note had been valued at substantially less than face.

The Tax Court held that the gain on the sale was taxable as ordinary income. Distinguishing the *Caulkins* case on the ground that section 117(f) was not applicable since there was no retirement, its rationale was the usual one for discount note situations, *i.e.,* that the interest element is separable from the capital asset element of the obligation and is properly taxable at ordinary income rates. Taxpayer argued that the face amount of the notes was the agreed purchase price of the iron ore land in 1917 and, accordingly, that the notes were not discount notes. The court stated, however, that it was obvious that the notes were not worth their face amount at the time of issuance and that "the value of the notes issued on the date of sale of the ore tracts to Oliver was the actual purchase price." It concluded that the increment in value of the notes represented compensation to taxpayer for the use of capital and was intended as payment of interest. Accordingly, since the basis of the note was its value at the time of issuance, the full amount of the gain was held taxable as ordinary income.

The Eighth Circuit reversed on the ground that the purchase price of the ore property was the full face amount of the notes. Consequently, the notes were not issued at a discount. This conclusion was reached on the basis that the documents of the parties had treated the face amount of the notes as the purchase price. It was bolstered by the fact that the notes were payable at face even if, because of acceleration on default or voluntary prepayment, they were paid prior to maturity.[36] As dictum the court stated: "This, of course, is not to say that purported, deferred purchase price cannot in any situation be found to contain disguised, intended interest."[37]

It is, however, difficult to understand when a portion of a deferred purchase price would be considered interest under the *Paine* opinion, except where there is bad draftmanship, or where the note issuer deliberately sets the transaction up to secure a deduction for a discount. If the parties take care to express the purchase price in terms of the face amount of the notes and write appropriate bolstering provisions, they would appear to bring their transaction under the terms of the *Paine* opinion. Obviously, the non-interest bearing long term notes of the *Paine* case were worth less than face. The sale was an arms-length transaction and with-

36. The court also appears to have placed some reliance on the particular facts of the situation and the method by which the purchase price was computed. The property was mineral lands and the price was set by multiplying a given price per ton by the estimated ore yield.
37. 236 F.2d at 403.

out convincing evidence to the contrary, it would seem to follow that the value of the ore lands was less than the face amount of the notes.[38] If so, the notes should be treated in the same manner as if purchased for cash equal to their fair market value.

Courts have shown a reluctance, however, to consider any part of a deferred purchase price as interest.[39] Where discount notes are issued for cash, it is perfectly clear that the issuer may take the amount of the discount as an ordinary deduction.[40] But where property other than cash is the consideration, the propriety of such a deduction is not yet completely settled.[41] It is not only tax law that has difficulties. In most states no part of a deferred purchase price is considered interest and consequently their usury laws do not apply to time sales.[42] The proposed regulations issued under section 1232 in 1956 included a provision on notes issued for property other than cash.[43] But it was not adopted and the final Regulations make no reference to the problem.

While the future of the law in this area is not at all clear, it appears to offer substantial opportunities to taxpayers. Especially is this so in view of the installment sale provisions under section 453. Section 453 (d)(1) provides that upon the disposition of an installment obligation, any gain or loss resulting "shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received." The Regulations reiterate this without qualification.[44] Ordinarily, in a transaction where a considerable amount of the price is to be deferred it is possible to come within the liberal terms of section 453. In many cases it will be worth making an effort to do so to

38. The only alternative is that the seller disposed of the property at less than its fair market value. If so, it still might be reasonable to treat the notes as at a discount even though the seller, by assumption, made a bad deal in the sale and has his injury compounded by ordinary income treatment.

39. Mills v. Commissioner, 52 F.2d 931 (4th Cir. 1931); Daniel Bros. Co. v. Commissioner, 28 F.2d 761 (5th Cir. 1928). But where a "lease" is held to be a sale, a portion of the payments are normally considered interest and may be deducted by the purchaser. *E.g.*, Chicago Stoker, 14 T.C. 441 (1950); Judson Mills, 11 T.C. 25 (1948), *acq.*, 1949-1 CUM. BULL. 2. See also Southeastern Fin. Co., 4 T.C. 1069 (1945), *aff'd*, 153 F.2d 205 (5th Cir. 1946).

40. Reg. § 1.61-12; Rev. Rul. 59-260, 1959-2 CUM. BULL. 137.

41. Montana Power Co. v. United States, 232 F.2d 541 (3d Cir. 1956) (dictum). In the *Paine* case the issuer apparently did not attempt to take any discount deduction. But, it is not clear that it did not receive as much benefit by considering the basis of the property received as the face amount of the notes.

42. Annot., 48 A.L.R. 1442 (1927); Annot., 57 A.L.R. 880 (1928).

43. Proposed Reg. § 1.1232-3(b)(1), 21 Fed. Reg. 5371 (1956) provides: "If an obligation is issued for property other than money, the determination of whether an original issue discount exists, and its amount, if any, depends upon the relationship between the fair market value of the property and the face amount of the obligation. If the obligation is issued in an arms-length transaction and bears fair rate of interest the face amount of the obligation will be presumed to represent the fair market value of the property, unless it appears that the parties to the transaction intended otherwise." This may be found in the unbound edition of the 1956 U.S. Code Congressional and Administrative News 6965.

44. Reg. § 1.453-9(a).

secure the support of the above provision which may be applied as section 117(f) was applied by the Sixth Circuit in deciding the *Caulkins* case.

GAIN ON NORMAL INTEREST BEARING OBLIGATIONS ON WHICH INTEREST HAS ACCRUED

Where gain on the sale or retirement of normal interest bearing obligations is attributable in whole or in part to accrued or earned interest the courts, in the few cases which have been decided, have not shown the hesitancy exhibited in the discount note area.[45] The interest element has been taxed as ordinary income.[46] The leading case in the area, *Fisher v. Commissioner*,[47] was decided by the Sixth Circuit (which also decided the *Caulkins* case). In the *Fisher* case the taxpayer sold six per cent notes, with a face amount of $133,849.44 on which $75,574.29 of interest was in default, for $200,000. Relying on assignment of income cases[48] the court found that the gain represented interest income.[49]

In the *Fisher* case all of the defaulted interest had accrued while taxpayer was the owner of the obligation. This situation must be distinguished from that where the taxpayer acquires obligations with interest already accrued and in default.[50] In such a case the defaulted interest when and if paid constitutes a non-taxable return of capital until the full basis of the bonds is recovered.[51] Gain on a sale of the obligations, even if attributable to the defaulted interest, will constitute capital gain.[52] And a payment of defaulted interest in excess of taxpayer's entire basis will be treated as a partial retirement of the obligation, with such excess taxable as a capital gain if the obligation is such that its retirement qualifies as a sale or exchange.[53] These favorable rules apply only to payments at-

45. Similarly, there has been no hesitancy in finding ordinary income (to the extent of tax benefit received) upon sale of an obligation previously charged off as a bad debt. Merchants Nat'l Bank v. Commissioner, 199 F.2d 657 (5th Cir. 1952), *affirming* 14 T.C. 1375 (1950); First Nat'l Bank, 16 T.C. 147 (1951).

46. Perhaps the most common situation of this type is the sale of bonds between interest dates. It has long been the rule that "part of the sales price represents interest accrued to the date of sale and must be reported as interest income." Reg. § 1.61-7(d). As a corollary the purchaser may exclude an equal amount from income upon receipt of his first interest payment.

47. 209 F.2d 513 (6th Cir. 1954), *affirming* 19 T.C. 384 (1952) *cert. denied*, 347 U.S. 1014 (1954).

48. *E.g.*, Helvering v. Horst, 311 U.S. 112 (1940). See discussion pp. 265-66.

49. *Accord*, Warner A. Shattuck, 25 T.C. 416 (1955). This case involved a dispute as to whether the disposition constituted a sale or a retirement which qualified under § 117(f). Although holding that there was no retirement, the court stated that even if § 117(f) applied, the gain attributable to accrued interest was taxable as ordinary income.

50. This is commonly referred to as a purchase of bonds "flat" because a single flat price is ordinarily paid as a single consideration for the principal obligation and the defaulted interest.

51. National City Lines v. United States, 197 F.2d 754 (3d Cir. 1952); Erskine Hewitt, 30 B.T.A. 962 (1934).

52. Clyde C. Pierce Corp. v. Commissioner, 120 F.2d 206 (5th Cir. 1941).

53. Estate of Hamilton C. Rickoby, 27 T.C. 886 (1957), *acq.*, 1960 INT. REV. BULL NO. 35,

tributable to interest accrued at the time taxpayer acquired the obligation — not to payments attributable to interest which accrued after taxpayer acquired the obligation.

SALE OF EVIDENCES OF INDEBTEDNESS DURING A 337 LIQUIDATION PERIOD

Under section 337 a corporation may adopt a plan of complete liquidation and if such liquidation is completed within twelve months thereafter no gain or loss is recognized (with certain stated exceptions) from the sale or exchange of property during the twelve month period. Even under this non-recognition section it has been held that the interest element of a transaction may be sorted out and taxed. In *Central Building and Loan Association,*[54] the taxpayer's sale of assets qualified under section 337. But, among the assets sold were notes on which there was over $30,000 of earned interest which had not yet become due and payable. The taxpayer's contention that gain attributable to such earned interest should not be recognized was rejected. The court stated that the non-recognition of gain under section 337(a) applies only with respect to a sale or exchange of property. It held that section 337 did not apply to the interest element because there was not a sale but the receipt and collection of interest.[55]

OBLIGATIONS PURCHASED WITH UNMATURED COUPONS DETACHED

A normal interest bearing coupon bond can be converted into a type of discount bond by the simple expedient of purchasing it with some or all of its interest coupons detached. Like a typical discount bond, if other factors remain equal, the worth of the obligation will gradually increase during the period covered by the detached coupons. Since section 1232 (a) applies only to bonds originally issued at a discount, the coupon

at 7; Rev. Rul. 60-284, 1960 INT. REV. BULL. NO. 35 at 28, *revoking* Rev. Rul. 55-433, 1955-2 CUM. BULL. 515. These authorities involved the application of § 117(f) of the Internal Revenue Code of 1939, ch. 1, 53 Stat. 52, but presumably the same rule would apply under § 1232(a) of the Internal Revenue Code of 1954.

54. 34 T.C. No. 43 (Dec. 24, 1960).

55. *Accord,* Rev. Rul. 59-120, 1959-1 CUM. BULL. 47 (gain on sale of one year non-interest bearing obligations ruled ordinary income where sale occurred during a §337 liquidation period).

56. Prior to amendment in 1958 the provision applied only where the purchaser did not receive all the coupons which first became payable more than twelve months after the date of purchase. As to obligations purchased after December 31, 1957, however, the provision applies if the purchaser did not receive all the coupons which first became payable after the date of purchase. Note that an obligation can fall within the original issue discount provision and also within the coupon detached provision. In such case the coupon detached provision applies first and the original issue discount provision can apply only to excess gain.