UNC SCHOOL OF LAW

NORTH CAROLINA LAW REVIEW

Volume 19 | Number 1

Article 4

12-1-1940

Effect of Discount Or Premium on Bondholder's North Carolina Income Tax

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EFFECT OF DISCOUNT OR PREMIUM ON BOND-HOLDER'S NORTH CAROLINA INCOME TAX

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I. BONDS NOT ISSUED BY GOVERNMENTAL UNITS

A. Acquired at a Discount

If a taxpayer, reporting income upon an accrual basis, becomes an original subscriber for a $1,000 ten-year corporate bond, paying therefor $950, or if, ten years prior to maturity, he purchases for $950 an outstanding $1,000 bond, does the discount so received represent, for North Carolina income tax purposes: (1) Taxable income in the year of subscription or purchase? (2) Taxable income to be spread over the period of his ownership, one-tenth of the discount being treated as income each year? (3) Taxable income, to the extent realized, upon sale or redemption?

There are no authoritative state judicial decisions or administrative regulations indicating which of these alternatives the taxpayer is to follow. If precedent is to be sought, therefore, it must be sought in the Federal cases and administrative rulings.

In its broadest significance discount might be said to include any amount by which acquisition price is less than the face value of an obligation. However, it does not result from the same factors in every case; and, for Federal tax purposes, it has not received the same treatment in every case. To what extent the differences in the Federal treatment are based upon differences in the factors responsible for the discount, and to what extent they are based on other more or less justifiable considerations, is a question which must be examined with some degree of care. At the outset it may be conceded that present Federal practices involve, on the surface at least, a welter of theoretical inconsistencies; that both administrators and judges have contributed to this state of affairs; and that neither the administrators nor the Board of Tax Appeals nor the Federal courts have ever undertaken a complete analysis of all these inconsistent practices in an attempt to show if or how they can be justified in relation to each other.

Conversely, it must be admitted that practical administrative considerations may be entitled to great weight even though they may lead to theoretical inconsistencies; and that both the taxpayer's convenience and state administrative efficiency are served when the state and Federal tax authorities follow the same rules. To some extent, therefore, the

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problem for the state is whether administrative factors and the advantages of uniformity will justify its acceptance of the Federal inconsistencies.

One type of discount is commonly described as a commission. As compensation for negotiating a loan or servicing it or for other alleged services duly rendered, a commission is deducted from the face amount of the loan before paying the money over to the borrower. This seems to be the primary type of discount which Federal practice recognizes as income, in its entirety, at the time the loan is made.[1] Originally, it was insisted that this was income at that time even when the recipient of the commission was on a cash basis,[2] but the Board of Tax Appeals and the courts thought otherwise,[3] and eventually the doctrine was admitted to apply only to taxpayers on the accrual basis.[4] There seems no necessity to quarrel with the general principle thus adopted. There is a surface inconsistency between it and the fact that, when a corporation issues bonds, selling commission may be amortized by it over the life of the bonds.[5] However, it can be argued, by way of explanation, that the commission is, to the issuing corporation, a cost of procuring capital which is properly amortized, while to the recipient in the business of negotiating loans or selling bonds it is ordinary income.

On the other hand, if a bank loans money on a non-interest bearing note, paying over to the borrower the face amount less some agreed sum approximating normal interest to maturity, it seems never to have been doubted that this discount is to be treated as interest for tax purposes. At one time, apparently, many banks entered it on their books as interest income when the loan was made and so reported it

[1] Columbia State Savings Bank v. Commissioner, 41 F. (2d) 923 (C. C. A. 7th, 1930); North-Western Trust & Savings Bank, 20 B. T. A. 365 (1930); The Bonded Mortgage Co. of Baltimore, 27 B. T. A. 965 (1933), *rev'd* on another point 70 F. (2d) 341 (C. C. A. 4th, 1934); Columbia State Savings Bank, 31 B. T. A. 685 (1934); S. M. 3820, IV-2 Cum. Bull. 32 (1925); G. C. M. 222, V-2 Cum. Bull. 110 (1926). The same result follows when the commission, instead of being handled by a discount or deduction, is represented by a separate note given by the borrower. American National Co. v. United States, 274 U. S. 99, 47 Sup. Ct. 520, 71 L. ed. 946 (1927). For a contrary result on particular facts, see Southern Abstract & Loan Co. v. Commissioner, 72 F. (2d) 130 (C. C. A. 6th, 1934).

[2] S. M. 3820, IV-2 Cum. Bull. 32 (1925).

[3] Blair v. First Trust & Savings Bank, 39 F. (2d) 462 (C. C. A. 5th, 1930), *cert. denied* 282 U. S. 851, 51 Sup. Ct. 29, 75 L. ed. 754 (1930); Helvering v. Martin-Stubblefield, Inc., 71 F. (2d) 944 (C. C. A. 8th, 1934); Commissioner v. Central Republic Trust Co., 75 F. (2d) 708 (C. C. A. 7th, 1935); Chicago City Bank & Trust Co., 24 B. T. A. 892 (1931); Cosmopolitan Bond & Mortgage Co., 30 B. T. A. 717 (1934). All of these cases held that commissions are income on the cash basis only when actually collected.

[4] G. C. M. 14839, XIV-1 Cum. Bull. 73 (1935).

[5] Helvering v. Union Pacific Ry., 293 U. S. 282, 55 Sup. Ct. 165, 79 L. ed. 363 (1934).

for taxation. However, it has since been held repeatedly that this is improper whether the taxpayer is on a cash or an accrual basis. Taxpayers on the accrual basis should report such discount as earned (i.e., if a 90-day note is discounted 30 days before the end of the taxable year, one-third of the discount is to be reported for that year);[6] while taxpayers on a cash basis are to report such discount only when the note is paid or sold.[7]

The decided cases involve primarily banks and loan companies, but the same principles should apply to other, more casual lenders who operate on a discount basis. One difficulty, of course, is to distinguish between discount which represents interest and discount which represents commission. The one is payment for the use of money and the other is payment for services rendered, but such clear verbal distinctions are often inadequate guides in practical situations. A commission can be nothing more than a device for evading the usury laws. However, the Federal tendency seems to have been to avoid the necessity for determining whether this is the case by accepting the lender's theory of the transaction.[8] Some judges have recognized that commissions may be nothing more than additional interest and might logically be amortized, but this has not induced them to depart from a distinction already established in practice.[9]

One of the administrative rulings intimates that discount is to be regarded as interest by the original lender only if the obligation is non-interest bearing, and expressly states that if the taxpayer acquires the obligation by purchase the discount can be regarded as interest only if the obligation is non-interest bearing.[10] This was not intended

[6] Chatham & Phenix National Bank, 1 B. T. A. 460 (1925); Bank of Hartsville, 1 B. T. A. 920 (1925); Madison & Kedzie State Bank, 1 B. T. A. 922 (1925); Western Exchange Bank, 12 B. T. A. 66 (1928); S. M. 3820, IV-2 Cum. Bull. 32 (1925).

[7] Mt. Vernon Trust Co. v. Commissioner, 75 F. (2d) 938 (C. C. A. 2d, 1935), *cert. denied* 296 U. S. 587, 56 Sup. Ct. 99, 80 L. ed. 415 (1935); Chemung Canal Trust Co., 30 B. T. A. 230 (1934), *aff'd* without opinion 74 F. (2d) 1009 (C. C. A. 2d, 1935), *cert. denied* 295 U. S. 751, 55 Sup. Ct. 829, 79 L. ed. 1695 (1935); First National Bank of Stoughton, Wis., 2 B. T. A. 586 (1925); First National Bank of Sonora, Tex., 6 B. T. A. 555 (1927). When partial payments are made the taxpayer on a cash basis is to report a proportionate amount of each payment as income attributable to the discount. I. T. 2526, IX-1 Cum. Bull. 123 (1930). The same rule was invoked in Shafpa Realty Corporation, 8 B. T. A. 283 (1927), though it does not appear positively whether the taxpayer was on the cash basis.

[8] S. M. 3820, IV-2 Cum. Bull. 32 (1925).

[9] The Bonded Mortgage Co. of Baltimore v. Commissioner, 70 F. (2d) 341 (C. C. A. 4th, 1934). For recognition of the fact that, from the standpoint of the borrower, commissions may affect the actual interest rate, see Helvering v. Union Pacific Ry., 293 U. S. 282, 55 Sup. Ct. 165, 79 L. ed. 363 (1934). Contrast the language employed in this case, with reference to discount and commissions, with that referring to premiums in Old Colony Ry. v. Commissioner, 284 U. S. 552, 52 Sup. Ct. 211, 76 L. ed. 484 (1932).

[10] S. M. 3820, IV-2 Cum. Bull. 32 (1925).

to mean that such discount would be treated as commission. It indicated that discount in such cases is neither interest nor commission, but can be considered for tax purposes only in determining whether there is gain or loss upon redemption or disposition of the obligation. Subsequent decisions of the Board of Tax Appeals are in accord with this in so far as it indicates that the purchaser, as distinguished from the original lender, can treat the discount as interest if the loan is non-interest bearing; but they seem to render somewhat doubtful the conclusion that discount cannot be treated as interest if the loan is interest bearing.[11]

Turning to bonds we find that, while there is no clear-cut line to be drawn between them and the other obligations mentioned, an entirely different approach has been followed.

In *New York Life Insurance Co. v. Edwards*,[12] arising under the 1913 Federal law, the Supreme Court held that premium paid for bonds could not be amortized by the purchaser over the life of the bonds, but could only be considered in determining gain or loss upon disposition of the bonds. This case has since been construed as authority for the Federal rule that neither premium nor discount on bonds is to be amortized by the purchaser.

An exposition of the theory is contained in the following language of the Board of Tax Appeals: "The petitioner undertakes to distinguish the decision of the court in *N. Y. Life Ins. Co. v. Edwards, supra,* from

[11] In Chicago Acceptance Co., 12 B. T. A. 150 (1928), "brokerage" or discount on notes, apparently non-interest bearing, purchased by a finance company from a truck dealer was held to be accruable as earned. In Vancoh Realty Co., 33 B. T. A. 918 (1936), the same rule was applied to discount on existing mortgage loans purchased through brokers. Apparently the loans were non-interest bearing, though the point is none too clear and, if so, the opinion seems to attach no particular importance to it. The language of the opinions (see the quotation in note 14, *infra*) would seem to apply with equal force, once the discount is determined not to be a commission, whether the loans also bear stated interest or not; though, conceivably, whether or not the loans are interest bearing might be of some importance in determining, in a disputed case, whether the discount represents commission.

In Bank of Rockingham, 3 B. T. A. 1137 (1926) the facts show positively that the notes were interest bearing. The taxpayer was on the cash basis, and so the discount was not income until collected; but there is no indication whatever in the case that this factor destroyed the character of the discount as interest and converted it into increase in capital. In fact, the implication is to the contrary, because the case was decided on the authority of earlier bank discount cases where non-interest bearing notes were involved.

If we are to assume that there is a difference between interest bearing and non-interest bearing notes, it should be noted that this is not quite the same principle as is invoked in the public security cases, subsequently discussed. There the governing factor is whether there is an issuing discount, whereas, in the present situation, a taxpayer purchasing a non-interest bearing note at a discount could treat the discount as interest even though the original lender received no discount; and, conversely, the purchaser of an interest bearing note could not treat discount as interest even if the original lender did receive a discount.

[12] 271 U. S. 109, 46 Sup. Ct. 436, 70 L. ed. 859 (1926).

this proceeding upon the grounds that returns of income under the Revenue Act of 1913, which was involved in the case cited, were required to be made on the basis of cash received and disbursed, whereas the petitioner's return for the year 1921 was made on the accrual basis. We think, however, that no accrual can be predicated upon the premium or discount at which a bond is purchased before a bond is sold or redeemed. Before sale or redemption of a bond nothing occurs to fix the amount which the holder thereof will actually realize from it (eliminating from consideration the matter of interest which is not in dispute here). The discount on the bond purchased below par is unlike interest, which is a fixed charge and accruing periodically. The right to receive this discount, or difference between the cost of the bond and its par, cannot be determined in advance as the bond may be sold for more or less than its cost, or, as in the case of many bonds, it may be redeemed prior to its maturity at an amount different from its principal or face amount of the bond. This discount is not earned or accrued in annual installments and cannot be income to the holder of the bond, either as additional interest or as a separate item of income. If anything, the annual amortization of this discount represents merely a theoretical appreciation in value unrealized by a sale or other disposition of the bond. It does not even represent actual appreciation as the current market price for the bond may be above or below the cost thereof as adjusted for previous amortization of the discount.

"The amount by which the petitioner has annually written up its bonds and correspondingly increased income on account of the amortization of discount thereon cannot represent income received or accrued to the petitioner under the definition of income as laid down by the courts in many cases. The converse is true in respect to the amortization of premium on bonds bought above par. The interest received from such bonds is not, in fact, diminished by annual charges made for the purpose of amortizing the premium. The fact that the petitioner may consider a part of this interest as set aside annually for the purpose of amortizing the premium does not diminish the actual interest received or accrued on the bonds. Nor does the setting aside of the annual amount for this purpose constitute a realized loss on the bonds as the Court has pointed out in *N. Y. Life Ins. Co. v. Edwards, supra.*"[13]

There are a number of weaknesses in this position. (1) Its result is contrary to the best accounting practices of taxpayers holding bonds in large amounts. (2) Subsequent language of the Board, referring to discount on mortgage loans, is in direct conflict with it.[14] (3) In

[13] Corn Exchange Bank, 6 B. T. A. 158, 161 (1927).

[14] See Vancoh Realty Co., 33 B. T. A. 918 (1936), in which it is said (at page 923): "Such discount, like interest, is earned with lapse of time. The

so far as it applies to issuing discount, it is inconsistent with the fact that the issuing corporation is required to amortize such discount.[15] (4) In so far as it apparently recognizes a fundamental difference between discount and interest it is, as will subsequently be seen, in conflict with the treatment accorded issuing discount on tax-exempt securities.

The origin of the difference in approach to discount on bonds and discount on other obligations is none too obvious. Very probably it grew out of the fact that in the early bank discount cases the notes were non-interest bearing to maturity, and the conclusion that the discount represented interest was virtually inescapable; whereas in the bond cases the discount is almost invariably in addition to a stated interest rate.[16] Perhaps a contributing factor was an idea that discount could be more readily treated as interest in connection with short-term than with long-term securities; though no attempt has been made to draw a line between the two and, in view of the mortgage loan cases, it is unlikely that one could be drawn for this purpose.[17] Perhaps

amount paid upon the purchase of a mortgage loan represents as a practical matter the present value of an obligation to pay in the future, which, in part, is based upon the extent of the unexpired term of the mortgage note, the financial responsibility of the obligor, the adequacy of the security, and the supply thereof and demand therefor. The undisputed proof shows that competition and the risks of the business were factors which affected the amount of the discount. . . . As the maturity of the obligation draws nearer, the value ordinarily increases. As the value increases with the lapse of time and the approach of the maturity date, the discount is being earned. Hence, when books are kept on an accrual basis, the discount should be accrued as thus earned, whether paid or not."

While this may not quite amount to saying that the discount is interest, its conclusion that the discount is accruable as earned is directly contrary to that reached in the *Corn Exchange Bank* case, quoted in the text.

[15] Helvering v. Union Pacific Ry., 293 U. S. 282, 55 Sup. Ct. 165, 79 L. ed. 363 (1934); Lincoln Mortgage & Title Guaranty Co. v. Commissioner, 75 F. (2d) 585 (C. C. A. 3rd, 1935), *cert. denied*, 296 U. S. 654, 56 Sup. Ct. 381, 80 L. ed. 466 (1936); U. S. Treas. Reg. 103, §19.22(a)-18.

The present Regulations merely provide for amortization; they do not undertake to define the nature of the discount. The Federal cases have not made too clear either the nature of the discount as it affects the issuing corporation or the exact provision of the statute which permits it to be deducted. It has been referred to as expense. Baltimore & Ohio R. R. v. Commissioner, 78 F. (2d) 456 (C. C. A. 4th, 1935). It has been held to be, in reality, additional interest, a proportionate part of which accrues annually. Western Md. R. R. v. Commissioner, 33 F. (2d) 695 (C. C. A. 4th, 1929). And it has been treated as loss sustained (though the Court recognized its relation to interest). Helvering v. Union Pacific Ry., *supra*. *Cf.* the Circuit Court of Appeals version of this case, 69 F. (2d) 67 (C. C. A. 2d, 1934).

[16] See S. M. 3820, IV-2 Cum. Bull. 32 (1925). *Cf.* I. T. 1684, II-1 Cum. Bull. 60 (1923). A bank savings plan took the form of a so-called investment bond, the depositor having a constantly increasing redemption value which would finally equal twice the original deposit. It was ruled that depositors on the accrual basis should accrue each year the excess of the redemption value at the year end over the redemption value at the beginning of the year.

[17] See United States v. Collier, 104 F. (2d) 420, 422 (C. C. A. 5th, 1939), in which the court said: "Where the transaction is a short term loan, and not the sale of a security on the market, the discount deducted is interest." However, no

there was a realization that bonds, particularly those listed on exchanges, are traded in more frequently, and that this would render more difficult the task of determining for each case the precise part of discount which can truly be said to represent interest (a matter subsequently discussed in greater detail). However, the main reason for the difference in approach must be the fact that the bonds are interest bearing. As already indicated, the Board of Tax Appeals has cast considerable doubt upon the validity of a distinction in the treatment of discount in the note cases predicated upon this. It is obviously an entirely arbitrary distinction. Is there any essential difference between (1) a \$1,000, one-year loan at par with 2% interest, (2) a \$1,000, one-year loan with a discount of \$10 and 1% interest, and (3) a \$1,000, one-year loan with a discount of \$20 and no interest? Strangely enough, under the distinction suggested, situations (1) and (3) receive identical treatment, while the *intermediate* situation alone drags in the capital increase notion. If this is the distinction, it is clearly unsound, whether it applies both in bond and note cases or whether, as may be possible, it operates only to draw a line between bonds and other obligations.

The language in the bond cases and the note cases is clearly not to be reconciled on the sole basis of the fact that in the one case the security is interest bearing and in the other it is not. When it is said that the right to receive discount cannot be determined in advance because the bond may be sold for more or less than cost, or that discount is unlike interest because it is not a fixed charge accruing periodically, or that amortization of discount does not necessarily reflect changes in market value, these statements would obviously be equally true in the case of non-interest bearing obligations. On the other hand, when it is said that discount on a non-interest bearing note is, like interest, earned with lapse of time, and that as the maturity date draws nearer the value of the note ordinarily increases, these statements are equally true in the case of interest bearing obligations.

The Federal practices could not suffer unduly if they were subjected to a mild dose of re-examination and clarification. Had no Federal rules been developed, the state would hardly arrive independently at the same results. However, are these results so objectionable that the state, at the cost of creating one more situation where Federal and state rules are confusingly different, should refuse to accept them? Looking solely at bonds, and assuming that they consti-

attempt is made in the opinion to implement this distinction with definitions. Further, the things distinguished are not necessarily inconsistent. A short-term loan may be a security and may be sold in the market, while a long-term loan may be privately negotiated.

tute a clearly defined class of securities, there are some factors which weigh in favor of the Federal practice.

It is now well settled that discount on bonds is to be considered, at some time and in some way, in computing income for tax purposes. The questions under discussion are only as to: (a) the particular year or years in which the discount is to be considered; and (b) whether, when considered, it is to be treated as interest or as realized capital increase.

If the taxpayer were allowed to amortize the discount, the primary reason would be that it constitutes interest. Such a theory is more difficult to apply to discount secured on purchase of bonds in the market than to issuing discount.

There are at least three general types of situations. (1) The bonds were issued at a discount and the market price, at the time of the taxpayer's purchase, is less than par only because of this and differs from issuing price only in proportion to the remaining life of the security—i.e., a ten-year, $1,000 bond issued at $950 is purchased by the taxpayer after five years for $975. (2) Market price varies from issuing price, whether the latter was par or less, because since the issuing date interest rates on comparable securities have gone up or down—i.e., the bond mentioned above is purchased after five years for $960 because such rates have gone up. (3) The market price varies from issuing price, whether the latter was par or less, because of other factors, chief of which would be collapse of the debtor's financial responsibility—i.e., a ten-year, $1,000 bond issued at par or at $950 is purchased after five years at $500.

Unless the entire discount in each case, regardless of size, be considered as amortizable, the task of determining just what part of it could be amortized might involve a tremendous amount of work. Perhaps it could be argued that all the factors which enter into the fixing of the market price also enter into the original fixing of the issuing price and interest rate and that, therefore, the purchaser should be entitled to regard any discount as amortizable interest. Obviously, however, the parallel is weak, because, where legitimate transactions are concerned, original issues of $1,000 bonds priced at $500 are not so common as to make investors think of them as transactions which serve to fix an effective interest rate. The market purchaser of a low-price bond clearly regards the profit he hopes to reap largely as a speculative increase in capital value and not as interest in the ordinary sense. Further, even if amortization of all discount were allowed, trouble would immediately be caused in the low-price situations by the general rule that any accrual of items which the taxpayer can't reasonably expect to receive is improper.

Other possible rules of thumb would be: (1) permit amortization of issuing discount only (as is done with public securities, later discussed); or (2) permit amortization of such an amount of discount as would, when added to interest received, not exceed an arbitrarily fixed percentage of the taxpayer's purchase price—say, 8%. Neither of these would follow accepted accounting practice; neither would take account of the actual extent to which discount represents interest in each case; neither would eliminate all present inconsistencies; and either would result in much bookkeeping and administrative difficulty.[18]

These considerations bolster somewhat the recognized desirability of uniformity in administrative practices, and the state may well follow the Federal policies as far as it may legally do so. This can reasonably be done without expressly approving the validity of all the legal reasoning in the Federal cases. It remains to be seen only whether the uniformity of practice may be complete under our statute.

The state law contains the following provision: "The net income of a taxpayer shall be computed in accordance with the method of accounting regularly employed in keeping the books of such taxpayer, but such method of accounting must be consistent with respect to both income and deductions, but if in any case such method does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the commissioner does clearly reflect the income, but shall follow as nearly as practicable the Federal practice, unless contrary to the context and intent of this article."[19] While this may not cover the precise matter in question, it clearly indicates approval of a general policy of uniformity.[20]

The Revenue Act also prescribes that, in computing gain or loss upon the disposition of property, cost shall be the basis.[21] Denial of permission to amortize discount obviously does not violate this provision.

The remaining inquiry is whether the fact that "unearned discount" is specified in the state statute as a deduction from gross income,[22]

[18] It may be noted, in partial defense of apparent Federal inconsistencies, that comparable difficulties are not inherent in allowing the issuing corporation to amortize discount (though there may be other troublesome questions there encountered). The amount to be amortized is not affected by subsequent market prices, since the issuing corporation's contract is fixed. A much smaller number of cases is involved and, on the average, the taxpayer's books are likely to be more adequate. And in the overwhelming majority of cases, if discount doesn't represent interest it represents selling expense, which is likewise recognized to be amortizable.

[19] Sec. 318(1), Ch. 158, N. C. Pub. L. 1939.

[20] See also Sec. 334, Ch. 158, N. C. Pub. L. 1939, requiring reports of Federal assessments and refunds to be made by the taxpayer to the state, thus further indicating a legislative desire for uniformity.

[21] Sec. 319, Ch. 158, N. C. Pub. L. 1939.

[22] Sec. 322(3), Ch. 158, N. C. Pub. L. 1939.

necessitates the allowance of amortization. The argument would be that unless discount is accruable and thus becomes a part of gross income, there could be no deduction for unearned discount; and that it is not to be assumed that a provision is without purpose. The answer would be that the provision is intended only to insure that discount not earned shall not be taxed; that if, following Federal practice, no part of it goes into gross income prior to realization, then obviously no part of it can be deducted; and that the provision has its proper application in connection with bank discount and other cases in which discount is conceded to be interest.

The difference in total taxes paid by the taxpayer, caused by denying the right to amortize discount, is likely to be much less under the state law than under the Federal law; and this is said without reference to the fact that the Federal rates greatly exceed the state rates. Under either law, over the entire period for which the securities are held, permission to amortize would not change total taxable income of all types, because any amortization would serve to decrease profit or increase loss upon sale or redemption. Under either law the total tax paid would vary to some extent, assuming other income to be constant, because of the progressive factor in the rates—i.e., taking the entire discount as income in one year might put the taxpayer in a higher rate bracket for that year. However, under the Federal law, a further variation is caused by the fact that the discount is treated as realized increase in capital value; and, while there would be no difference of treatment as between interest realized in a particular year and "ordinary" gain realized in the same year, a very material difference results when the gain, as it ordinarily would in the case of bonds, falls within the statutory definition of "capital gain".[23]

By contrast, except in one respect, there is no such difference of treatment under the state law. The one limitation for state purposes is that loss on sale of securities held less than two years may be deducted only from security gains.[24] In all other situations capital losses are deductible from ordinary income, of which capital gains are a part.[25]

[23] The present Federal statute is Int. Rev. Code, §117 (1939). Earlier versions of the Federal law did not include gain on retirement or redemption of bonds, as distinguished from gain on sale or exchange, within the definition of capital gain. However, beginning with the 1934 Revenue Act, any gain from retirement of a bond issued in registered form or with interest coupons is treated as capital gain.

[24] Sec. 322(6), Ch. 158, N. C. Pub. L. 1939.

[25] Interpretation of the limitation on security losses presents questions affecting security transactions regardless of whether discounts or premiums are involved, the only effect of the latter being to vary the amount of the loss or offsetting gain. The restrictive provision mentions only *sale* of stocks or bonds. Would this include loss on redemption or exchange (other than tax-free) of such securities? On analogy to Federal decisions, it probably would not. See Fairbanks v. United States, 306 U. S. 436, 59 Sup. Ct. 607, 83 L. ed. 855 (1939). However, if the

One further difference between state and Federal laws may be noted. As to bonds purchased at a discount prior to March 1, 1913, market value as of that date would be the Federal basis for gain or loss.[26] Under the state law the 1913 date has no significance; nor does January 1, 1921, effective date of the state law, have any significance if actual cost of property acquired prior to that time can be determined.[27] Failure to give the taxpayer the benefit of any increase in market value taking place prior to that date raises a question of constitutionality not within the scope of this article, but it would seem, under existing authority, that it is constitutional.[28]

B. Acquired at a Premium

If a taxpayer subscribes for, or subsequently purchases, a $1,000 corporate bond for $1,050, in what year or years will the $50 premium enter into the computation of his taxable income?

As clearly indicated by the foregoing discussion and the authorities there cited, the Federal rule as to bond discount applies also to bond premium. The subscriber or purchaser is not permitted to amortize either, and neither is considered in computing taxable interest. The taxpayer must wait until disposition of the bond before either discount or premium enters into the computation of his taxable income. Here again this differs from the treatment accorded the issuing corporation, which must amortize any premium it receives.[29]

In *New York Life Insurance Co. v. Edwards*[30] the taxpayer, a large insurance company, in seeking permission to amortize premiums on bonds held by it, argued that amortization was accepted accounting practice, that it was in harmony with the New York law governing

loss occurred upon final distribution of corporate assets, the limitation would apply. See the Attorney General's letter of Nov. 22, 1939, to the Commissioner of Revenue, C. C. H. 1939, N. C. Corp. Tax Serv. ¶15-099.

[26] O. D. 475, 2 Cum. Bull. 211 (1920).

[27] Sec. 319, Ch. 158, N. C. Pub. L. 1939.

[28] Norman v. Bradley, 173 Ga. 482, 160 S. E. 413 (1931), appeal dismissed for want of a substantial Federal question, *sub nomine* Glenn v. Doyal, 285 U. S. 526, 52 Sup. Ct. 404, 76 L. ed. 923 (1932).

[29] Helvering v. Union Pacific Ry., 293 U. S. 282, 55 Sup. Ct. 165, 79 L. ed. 363 (1934). If the bonds were issued prior to March 1, 1913, the premium represents income received prior to that date and is not taxable through amortization. Old Colony R. R. v. Commissioner, 284 U. S. 552, 52 Sup. Ct. 211, 76 L. ed. 484 (1932); U. S. Treas. Reg. 103, §19.22(a)-18. No similar limitation applies to discounts.

While permitting amortization to the issuing corporation, neither the Court nor the Board of Tax Appeals has been willing to concede that the premium is so related to interest that it simply serves to reduce the annual interest deduction of the debtor. Old Colony R. R. v. Commissioner, *supra;* Fall River Electric Light Co., 23 B. T. A. 168 (1931). Technically, therefore, the inconsistency existing between the rules applying to the issuing corporation and the rules applying to the subscriber is one of practical treatment rather than legal theory.

[30] 271 U. S. 109, 46 Sup. Ct. 436, 70 L. ed. 859 (1926).

insurance companies, that it had been upheld in trust estate cases, and that the actual interest income could be determined only by reference to the premiums. However, the Court said: "Unless the addition amounted to 'a loss actually sustained within the year', no deduction could be made therefor. Obviously, no actual ascertainable loss had occurred. All of the securities might have been sold thereafter above cost. The result of the venture could not be known until they were either sold or paid off."[31] At least one state court has adopted the same viewpoint.[32]

Many of the considerations mentioned in connection with discounts operate to make it advisable for the state to conform to the Federal rules. Here again it is conceded that the premium is to be taken into consideration at some time. If a ten-year bond, $1,000 par, costs the original subscriber $1,050 and is sold five years later for $1,040, the result under the Federal rule is a loss in the year of sale of $10. If amortization were allowed, there would be a reduction of the basis to $1,025; there would then be a gain in the year of sale of $15; and the difference between the total amortization deductions of $25 and the final gain of $15 would be the same $10 net loss. The only controversy is over the time element and the character ("ordinary" or "capital") of loss or gain; and, as already explained, this latter is much less important under the state law than under the Federal law.

Perhaps practical considerations do not favor the Federal rule as strongly in the case of premiums as in the case of discounts. In the main, a premium is paid for a bond or note only if it bears interest at a rate greater than the rate borne by equally safe securities selling at par; and this is true as to both original subscription and subsequent purchase. There are other factors which might influence the price, such as ability to convert the bonds into other securities at a potentially advantageous value, or the possibility of redemption at a premium prior to maturity. However, these factors would not ordinarily be present; and there is certainly no factor ordinarily entering into premium comparable to collapse of the debtor's responsibility as a factor entering into discount. In the overwhelming majority of cases, premium could be considered as controlled primarily if not exclusively by the interest rate on comparable securities, which would logically lead to permission to amortize except in unusual cases. Nevertheless, this possibility of greater ease of administration, by comparison with discounts, would not, standing alone, justify departure from the Federal rule, particularly when the latter is still more simple to administer. There is no provision in the state law, comparable to the "unearned

[31] *Id.* at 116.
[32] Van Dyke v. Milwaukee, 159 Wis. 460, 146 N. W. 812 (1914).

discount" provision, which raises a question as to the right to deny permission to amortize premium.

This acquiescence in the Federal practice is advocated solely in the interest of simplicity of administration and uniformity of practice. As will subsequently be apparent, the writer does not accept the judicial viewpoint that premium and interest are so unrelated that premium cannot ever be considered as establishing the effective interest rate.

II. Bonds Issued by Governmental Units, Interest from which is Tax Exempt

A. Acquired at a Discount

Even when it was generally agreed that Federal and state governments could not tax the interest from each other's bonds, it was held that gain resulting from sale or disposition of such securities was taxable.[33] Consequently, if we take literally the professed reason for the Federal rule as to private bond discount,[34] that discount is fundamentally different from interest, it should follow that, upon disposition of the security, anything received on account of the discount is taxable. The weakness of the distinction is indicated by the fact that it has not been followed in the public security field, where determination of what constitutes interest has its greatest importance. It has been recognized there that issuing discount, at least, is related to and may be the equivalent of interest.

The *Willcuts* case expressly left open the question of whether there could be taxable gain upon exempt government securities to the extent that such gain represented only issuing discount. However, Congress had already provided that, for tax exemption purposes, discount on non-interest bearing Treasury bills should be regarded as interest.[35] More recently it enacted a similar provision with reference to increment in

[33] Willcuts v. Bunn, 282 U. S. 216, 51 Sup. Ct. 125, 75 L. ed. 304 (1931): Similarly capital gain on Federal bonds is subject to Federal income tax, at least, unless the statute authorizing the bonds plainly exempts such gains. The exemption of "interest" or of "income" is not enough: Central Hanover Bank & Trust Co. v. United States, 83 Ct. Cl. 401, 14 F. Supp. 541 (1936), *cert. denied* 300 U. S. 678, 57 Sup. Ct. 668, 81 L. ed. 882 (1937); United States v. Stewart (U. S. Supreme Court, Nov. 12, 1940); Stern Bros. & Co. v. Commissioner, 108 F. (2d) 309 (C. C. A. 8th, 1940), *aff'd* without opinion, U. S. Supreme Court, Nov. 12, 1940.

Not within the scope of this article is the question of whether Congress can, by statutory language sufficiently plain, exempt capital gains on Federal bonds from state income taxation. The *Willcuts* case casts considerable doubt on its power to do so. The question would have become important if the *Stewart* case had construed the exemption provision as including capital gains, so the provision expressly applied to state as well as Federal taxes.

[34] Corn Exchange Bank, 6 B. T. A. 158 (1927).

[35] Pub. L. No. 11, 71st Cong., 1st Sess. (June 17, 1929). See also T. D. 4276, VIII-2 Cum. Bull. 83 (1929).

value of the non-interest bearing U. S. Saving ("Baby") Bonds.[36] Administrative rulings have extended the same doctrine to non-interest bearing municipal notes[37] and to interest bearing municipal and state bonds.[38] These statutes and rulings make it apparent that, in the public security field, so far as issuing discount is concerned, there is no distinction made between bonds and other types of obligations or between interest bearing and non-interest bearing obligations.

As far as bonds are concerned, what is the difference between a discount on a private bond and a discount on a public bond? The essential question is whether discount is interest; and it is very difficult to see how this could vary, from either the economic standpoint or the standpoint of legal theory, dependent upon whether the borrower is a private corporation or a government.

Is there, then, any justification for the difference in treatment? If so, it must be found in the fact that in the case of private securities the discount is clearly taxable, regardless of what it is, and the secondary problems, as to when and by what method the amount shall be taxed, are the only actual problems presented. On the other hand, in the case of public securities, the primary problem, as to whether the discount is taxable at all, must be settled because of the statutory and (it will here be assumed) constitutional provisions which entitle "interest" to exemption. It seems not unreasonable that practical administrative difficulties, such as those discussed at length above, should be given great weight in determining questions of time and method, while being given much less weight, or none at all, in determining a question of exemption or taxability.

The difference in treatment of issuing discount on public and private bonds has not received authoritative judicial sanction, presumably because the statutory and administrative rules as to public

[36] Pub. L. No. 3, 74th Cong., 1st Sess. (Feb. 4, 1935). See also I. T. 3263, 1939-1 Cum. Bull. 96. These Savings Bonds belong to that class of Federal securities given only a limited exemption from Federal income taxation. Interest from principal (aggregate for the class) exceeding $5,000 is subject to surtax. In applying this provision, it has been ruled that taxpayers on an accrual basis are to be regarded as receiving interest from the principal amount (which is issue price) of their Savings Bonds annually, while those on a cash basis are to be regarded as receiving it upon redemption. G. C. M. 15875, XIV-2 Cum. Bull. 100 (1935); I. T. 2958, XV-1 Cum. Bull. 120 (1936). There is no provision of the state law giving rise to a problem of precisely this character.

[37] G. C. M. 10452, XI-1 Cum. Bull. 18 (1932); *cf.* I. T. 2674, XII-1 Cum. Bull. 96 (1933), stating that when a city issued non-interest bearing notes for property, the total amount of the notes exceeding the cash price of the property, no part of the notes could be treated as exempt interest.

[38] I. T. 2629, XI-1 Cum. Bull. 20 (1932); G. C. M. 21890, 1940-13 Cum. Bull. 2. The first held that when 4% municipal bonds were issued at a discount to yield 4.5%, the discount represented tax-exempt interest. The second held that when interest bearing state bonds, issued at a discount, were redeemed at a premium prior to maturity, the entire discount (though not the premium received) represented tax-exempt interest.

bonds are generally favorable to the taxpayer. However, it is difficult to see how the courts, when presented with the exemption problem, could fail to recognize the connection between issuing discount and interest, regardless of troublesome expressions in private bond cases—that is, so long as we still have express statutory, if not constitutional, exemptions. Certainly in the absence of authoritative pronouncements, it should not be assumed that the questionable doctrine of the private bond cases (whatever practical considerations may there favor the result reached) will be carried over into the public bond cases, where the questionable character of the doctrine would be more manifest and its ultimate net results more important. The state should clearly follow the present Federal practice as to issuing discounts on public securities, at least where dealing with the original subscriber.

The Federal treatment of discount when public bonds are purchased after they are outstanding depends upon whether the bonds were originally issued at a discount. The rule, as illustrated by its application to Treasury bills[39] and to municipal bonds and notes, both non-interest bearing[40] and interest bearing,[41] is that the issuing discount is apportioned to each successive holder in proportion to the percentage of the entire life of the security for which he holds it.[42] That is, if a ten-year, $1,000 bond originally issued at $950 is purchased by the taxpayer after five years for $975, his market discount represents exactly his portion of the issuing discount and is non-taxable interest, so that upon redemption at maturity at par he has no gain or loss. If his purchase price was $960 he would have, upon redemption, a gain of $15 (the difference between his realized market discount and his portion of the issuing discount). In the latter case, if he did not hold it until

[39] T. D. 4276, VIII-2 Cum. Bull. 83 (1929). Since market price on these bills varied little from issuing price plus accrued discount, and the necessary bookkeeping to compute gain or loss tended to be more complicated than important, Congress subsequently provided that neither gain nor loss should be recognized in connection with them. Pub. L. No. 376, 71st Cong., 2nd Sess. (June 17, 1930). See T. D. 4292, IX-2 Cum. Bull. 102 (1930).

[40] G. C. M. 10452, XI-1 Cum. Bull. 18 (1932).

[41] I. T. 2629, XI-1 Cum. Bull. 20 (1932).

[42] This rule was not arrived at originally for state and local securities. The early rulings were summarized in G. C. M. 1455, VI-1 Cum. Bull. 87 (1927). At first all discount was regarded as distinct from interest, hence taxable. Then it was conceded that issuing discount represented tax-exempt interest to the taxpayer holding to maturity; but if the subscriber sold prior to maturity he was not allowed to treat any part of such discount as interest, the idea being that he never actually received the discount from the unit itself and that only the unit itself could pay tax-exempt interest. Further, no discount received by a purchaser other than the original subscriber was regarded as tax-exempt interest, even in cases in which there was an issuing discount. G. C. M. 10452, XI-1 Cum. Bull. 18 (1932) re-examined the various rules, compared them with the treatment accorded Treasury bills, and concluded that discount on other exempt securities should logically receive the same treatment as that on the bills. None of the rulings conceded that purchase discount in excess of issuing discount could be regarded as exempt interest.

redemption, but sold it after two years for $990, he would have taxable gain of $20—that is, while the total difference between his purchase price and his sale price is $30, this is subject to reduction by his portion of the issuing discount which, for two years, totals $10.[43] It will be seen that the effect of this is to permit amortization of the issuing discount and to treat it as tax-exempt interest, whereas any additional discount received in the subsequent purchase may represent taxable gain. In no case may total discount treated as tax exempt interest, regardless of the number of successive holders, exceed issuing discount. It follows that where securities not originally issued at a discount are thereafter purchased at a discount, none of the discount represents tax-exempt interest, but all may be taxable gain.[44]

Is this distinction between "issuing" discount and "purchase" discount justifiable? From the standpoint of the taxpayer, logic would require a negative answer, because clearly in some cases, at least, the "purchase" discount will represent only the result of increase in current interest rates since the security was issued. Again, however, this logic would require administrative authorities to determine in each case whether it actually represents that or something else such as a material change in the issuing unit's credit rating, and we are back to situations in which practical difficulties must be given great weight.

[43] Correspondingly, according to the Federal rulings, if his sale price in the last-mentioned case had been $950, he would have a deductible loss of $20 ($10 difference between purchase and sale prices plus his $10 portion of issuing discount). This is an unsound rule which should not be followed by the state. The taxpayer's portion of issuing discount, if received, would be exempt interest. Had he accrued it, reported it and paid tax on it, his failure to receive it would give rise to a deduction; but that has not been done. A deduction for interest can arise only from a prior taxable accrual, not from the mere failure to receive anticipated interest. It has properly been held that failure to receive interest, accrued on the taxpayer's books but tax-exempt, does not give rise to a deduction. District Bond Co. v. Commissioner, 113 F. (2d) 347 (C. C. A. 9th, 1940). It is difficult to see how discount treated as tax-exempt interest could stand in any more advantageous position. No actual loss has been suffered, and since the State law allows only actual losses to be deducted, the state should not follow this Federal practice, despite the desirability of uniformity.

A rule of thumb might be that discount on public securities, to the extent that it represents tax-exempt interest, can operate to reduce or eliminate gain upon sale of the security; but it can never operate to give a loss deduction greater than the excess of actual acquisition price over actual disposal price. (As to whether, in every case, recognizable loss should be as great as such excess is a problem subsequently discussed.)

The Federal practice apparently rests upon the assumption that, when the security is disposed of, the price received should first be applied to the seller's portion of issuing discount; and that this leaves only the balance to be treated as return of capital. In the writer's view, this is contrary to everyday conceptions as to what takes place. It is much more in accord with those conceptions to treat the price received as first applicable to return of capital actually invested.

[44] Central Hanover Bank and Trust Co. v. United States, 83 Ct. Cl. 401, 14 F. Supp. 541 (1936), *cert. denied* 300 U. S. 678, 57 Sup. Ct. 668, 81 L. ed. 882 (1937) (Liberty Bonds); O. D. 729, 3 Cum. Bull. 123 (1920) (Treasury certificates of indebtedness).

It has already been pointed out that, whatever expressed judicial theories may be, the actual justification for differentiating between discounts in the private and public bond cases is the necessity of isolating *exempt* interest in the latter. We might expect, therefore, that the differentiation would cease when the necessity for it ceases, and that is apparently what has happened. The exemptions, whether statutory or constitutional, extend only to the interest paid by the issuing government. At its broadest this can include only stated interest plus issuing discounts. By them the unit's contract becomes fixed. Whether the market price of the bonds is more or less than the issuing price, the amount to be paid by the unit cannot be varied (except by its own purchases of the securities before maturity or by refunding operations involving exchanges, which are not controlling considerations). It follows that, even though the purchaser regards his discount as fixing his effective interest rate (and even though he may be right), if the rate so fixed exceeds the rate payable by the unit the excess would not be *exempt* interest. This excess stands in the same position as discount on private bonds and can be treated in the same way; and this is, in effect, the result of the Federal rules. Here again, despite logical inconsistencies, the state, to secure uniformity, may follow the Federal lead, except to the extent that to do so would involve giving a loss deduction based on failure to receive anticipated discount.[45]

The writer is not unaware that the near future may bring a great curtailment of exemption for interest on public securities. The Federal government is, of course, already taxing interest from many of its issues; and there would seem to be no doubt of the state's power to tax interest on future issues floated by it and its subdivisions.

The recent public salary cases[46] may, as many believe, indicate that the Supreme Court will, when called upon, find that the levy of a Federal tax on state bond interest, or *vice versa,* is not such a direct, substantial or discriminatory burden on the borrowing power as to violate constitutional principles. And, in the light of the current phenominal revenue needs, there are not lacking indications that legislation may soon be forthcoming to test the question.[47]

[45] See note 43, *supra.*

[46] Graves v. People of State of N. Y. *ex rel.* O'Keefe, 306 U. S. 466, 59 Sup. Ct. 595, 83 L. ed. 927 (1939); State Tax Commission of Utah v. Van Cott, 306 U. S. 511, 59 Sup. Ct. 605, 83 L. ed. 950 (1939).

[47] An amendment providing for taxation of interest from all future issues of public securities, offered to the recent Excess Profits Tax Bill by Senator Brown of Michigan, was defeated by a narrow margin, but there is no assurance that this result may not soon be reversed, despite the opposition of organized State officials.

North Carolina has already provided for taxation of Federal interest if and when Congress attempts to tax state interest. See Sec. 317 (2) (d), Ch. 158, N. C. Pub. L. 1939.

Such curtailment of the interest exemption as these developments may foreshadow would obviously, upon arrival, reduce the importance of the public security discount problem here discussed; and might well result in treating public security discount, to the extent of such curtailment, on the same basis as private security discount. It seems unlikely, however, that the exemption will be completely eliminated in the near future. There is nothing presently indicating that the state legislature contemplates taxation of interest on future issues of the state and its subdivisions. Further, the state, and probably the Federal government, cannot tax interest on past issues floated under statutes expressly granting interest exemption. Even if taxation of future interest on past issues should be permitted, a question would still remain as to issuing discount on such past issues. To some considerable extent, therefore, this problem seems likely to remain with us for some time.

B. Acquired at a Premium

As already indicated, a taxpayer, under Federal rules, is not permitted to amortize a premium paid for private securities, whether paid upon original subscription or later purchase. It thus is treated as having no relation to interest received, but (at least in cases of acquisition since March 1, 1913) as being part of the cost of the security which is taken as the basis for determining gain or loss upon disposition. No distinction is made between premium on private securities and premium on public securities by either the Federal administrative authorities[48] or the Board of Tax Appeals.[49] However, for this purpose, premium should not be confused with accrued interest. When a transaction is so handled that accrued interest is a separate part of the price, that part is not to be considered in determining the purchase or sale price for gain or loss purposes.[50]

Whether the state should follow this part of the Federal practice is a question currently of considerable importance. Most high grade public securities of older issues are now selling at substantial premiums. Further, certain brokerage houses have been advising their clients, in making bids for new offerings, to make their bids on a basis of a high interest rate and a premium rather than a low interest rate and par, the theory being that the net interest received will be the same and the premium will eventually be deductible for tax purposes by virtue of being considered part of the purchase price. (What better illustration could be asked of the extent to which legal thinking has departed from

[48] O. D. 726, 3 Cum. Bull. 49 (1920); *cf.* G. C. M. 1455, VI-1 Cum. Bull. 87 (1927).

[49] John H. Watson, Jr., 27 B. T. A. 463 (1932); Cornelia W. Roebling, 37 B. T. A. 82 (1938).

[50] I. T. 2050, III-2 Cum. Bull. 16 (1924).

practical finance?) Casual inspection of newspaper stories of county and city issues recently sold by the state's Local Government Commission does not reveal that, as yet, this advice has materially affected successful bids, but it remains a distinct possibility.[51]

In the writer's view, the state should not follow the Federal practice as to premium on exempt securities. There are two lines of reasoning which support this view.

(1) Suppose that the taxpayer subscribes for a $1,000, ten-year, 4% bond at $1,050. There is no doubt that, in such a case, the taxpayer pays the $50 premium because he expects to receive the 4% interest. He anticipates that the premium will be returned to him out of the interest and the balance of the interest will be his net return from the investment. That, as a practical matter, in the average case, this premium is to be interpreted as an adjustment of the interest rate, rather than as a true capital expenditure is hardly to be doubted. Bond prices are universally analyzed in terms of "yield" rather than stated interest rates. Most large security holders recognize the principle by amortizing the premium on their books. And, from the other side of the transaction, the successful bid on local government securities in North Carolina is determined by considering both stated interest rate and premium. As already seen, the Federal statutes and administrative authorities have, in the public security field, recognized the connection between issuing discount and interest. Why no similar recognition has been given to the connection between issuing premium and interest is not apparent; but it certainly should be given. If it were given, then the "cost" which is the basis for gain or loss would be considered as embracing only true capital investment, or par, and the premium would be eliminated in determining gain or loss, at least where the subscriber holds the security until maturity. Or, if it be insisted that "cost" basis must be construed to include the entire sum paid out, then so much of it as represents premium may be regarded as recovered by the taxpayer through his receipt of interest. There is no sound reason why the subscriber should be allowed to treat an issuing discount as tax-exempt

[51] County and city bonds and notes, which must be sold through the Local Government Commission, can be sold to the bidder whose bid will result in the lowest interest cost to the unit. N. C. CODE ANN. (Michie, 1939) §§2492(15), 2492(16). The lowest interest cost is determined by deducting premium bid from the total interest requirements over the life of the security. Thus, on a one-year note for $1,000, a bid of 5% interest with a $40 premium would take precedence over a bid of 2% interest at par.

What the practice may be in other states is immaterial, as the interest from the securities of other states and their subdivisions is taxed by North Carolina, and such securities can be treated in the same manner as private securities. Throughout the article "public securities" is used, so far as it affects the state income tax, to include only securities of the Federal government, North Carolina, its subdivisions, and such of their agencies and instrumentalities as fall within the exempt class.

interest and also treat issuing premium as purely capital investment, completely disassociated from interest, which lays the basis for inevitable future loss.

If this line of reasoning is followed, the amount of the premium might still be of importance if the subscriber sells the security before maturity. If he subscribes $1,050 for a $1,000 ten-year bond, at the end of five years he has received half the interest and has then been refunded half of his $50 premium. If he sells the bond for $1,010, he has a deductible loss of $15—that is, the difference between his remaining "investment" of $1,025 and his sale price. In other words, the premium is amortized.

Suppose a ten-year, $1,000 bond is issued at par and the taxpayer buys it after five years for $1,050. Upon redemption at maturity at par, does he have a deductible loss? The answer should be in the negative. In discussing discounts it will be found that the only distinction made between public and private bonds was as to issuing discounts; but there is no reason why this limitation should affect premiums. As to discounts, it was pointed out that purchase discount, while concededly it might well be related to the interest received by the taxpayer, had no relation to *exempt* interest since that was fixed by the issuing unit's contract. On the other hand, when dealing with premium, our question is not what part of the return from a given transaction represents tax exempt interest, but whether a part of the taxpayer's capital investment has actually been lost.

In the case put, the purchaser sees fit to buy a $1,000 bond, having five years yet to run, for $1,050. So far as he is concerned there is no difference between this and subscribing originally for a $1,000, five-year bond at $1,050. He would treat the two transactions in the same manner on his books; he will analyze them equally in terms of yield; and, if he holds to maturity, he will in each case receive exactly what he anticipated. We conclude, therefore, that should this first, or "amortization," theory be adopted, it would apply both to issuing and to purchase premiums. The tax liability of the purchaser paying a premium would be uninfluenced by whether the bond was originally issued at par, at a premium, or at a discount. The actual premium he pays and the remaining life of the bond are the governing factors.

It must necessarily be conceded that, in so far as this treats premium as directly related to interest it is plainly contrary to the reasoning of the Federal cases. As already pointed out, even when allowing the issuing corporation to amortize premium, it has not been recognized that premium is to be regarded as reducing the "effective interest rate."[52]

[52] See note 29, *supra*. In Old Colony R. R. v. Commissioner, there cited, the Court seemed, in fact, slightly annoyed that the accountants had thought up such an outlandish doctrine as that of "effective interest rate."

However, in the writer's view, for the reasons already indicated: (a) this reasoning is erroneous because not grounded on legitimate business practice; (b) even if premium has nothing to do with interest, the fact remains that the subscriber or purchaser, when he receives exactly what he contracts for, should not be considered as suffering a loss.

The North Carolina statute allows as deductions only losses "actually sustained".[53] If the writer's view is correct, to allow deduction of premium as a loss, when the taxpayer receives his interest and then receives the par value of his bond, would be a clear violation of this provision; and, despite the reasoning of the Federal cases and the general policy favoring uniformity, the Federal rule should not be followed unless constitutional considerations would compel the state to do so. Possible constitutional objections are discussed below in connection with a broader, alternative theory. It need be said here only that there is no sound reason why they should operate to prevent the state from proceeding under this first theory.

The justification for thus differentiating between premium on public securities and premium on private securities is to be found in the fact that, in the case of private securities, the annual interest is taxed. Since this is discussed at some length below, there is no need to elaborate it here.

If this theory were adopted, a taxpayer subscribing for or purchasing a public bond at a premium would never have a loss unless he disposed of it for less than par plus unamortized premium.[54]

(2) The second, and broader, theory is that the holder of a public bond can never have an actual loss unless his total receipts from it amount to less than he paid for it.

If the taxpayer pays $1,050 for a $1,000, ten-year, 4% bond and holds it to maturity, he has received back $1,000 in principal and $400 in interest, or a total of $1,400. Clearly the result of his transaction is a net profit, of some kind, of $350. Neither he nor anybody else could conceive of the transaction as actually representing a loss.

It must be admitted that this theory, if adopted, would lead much

[53] Sec. 322(6), Ch. 158, N. C. Pub. L. 1939.

[54] A difficult problem might be presented under this theory if the taxpayer actually receives less than the stipulated interest. Suppose he subscribes $1,050 for a $1,000, ten-year, 4% bond, receives his 4% interest for the first five years, and then agrees to take 3% interest for the remaining five. Has he a loss and, if so, how much? If he does have a loss, it could hardly be more than a proportionate part of the premium. That is, for the first five years his annual amortization of premium would still be $5, while for the last five it would be at least three-fourths of $5, or $3.75. His loss would not exceed the balance of $1.25 per year for the last five years, a total of $6.25. It would be preferable, however, so long as interest received each year totals an amount sufficient to offset the $5 amortization charge, to regard it as applicable to that purpose. This would mean, of course, that in the case put there would be no deductible loss.

further than mere disallowance of premiums as losses. It would mean adoption of a general rule that there could be no loss unless total principal and interest receipts were less than the purchase price, whether the latter be par or included a premium or discount. Suppose a $1,000, 4% bond is purchased at par and held for six years and then sold for $800. We have undoubtedly been accustomed to thinking of this as representing a loss of $200; yet actually the taxpayer has received a total of $1,040 for his $1,000 investment. Where is his loss? There could be none from the entire transaction unless the sale price fell below $760. There is no reason, other than the conventional modes of thought about "capital loss", for permitting a loss deduction in such a case.

Of course, when total receipts exceed payments it does not follow that there is taxable gain or profit; it follows only that there is gain and, therefore, there can be no loss. To determine what is taxable gain requires segregation of exempt interest—a segregation entirely unnecessary for loss purposes.

Does this suggestion involve an unjustifiable failure to take account of the fact that in the case last put the taxpayer has not received what he expected to receive and, therefore, has suffered a loss? No more than the commonly accepted fact that, if he is forced to accept 3% interest instead of a stipulated 4% he has suffered no tax loss (unless he has already accrued the 4% and reported it for taxation).

Does the theory involve an unwarranted failure to differentiate between "capital" and "interest" or "income"? That is, in computing the allowable loss from sale of securities, must we credit against the original capital investment only such amounts received as are conventionally recognized as return of capital, and not those which, like annual interest payments, are ordinarily regarded by the recipient as something which he can spend immediately and still leave his capital intact? But, assuming that capital and income are capable of precise and mutually exclusive definition, and disregarding the fact that income after receipt can and does become capital, is there any reason why the distinction should have importance in the present situation? No attempt is being made to tax as income something which should be regarded as capital. No attempt is being made to tax anything connected with the transaction. The only question is whether the transaction involves a loss which can be used to offset other income; and there is no reason why capital and income should be distinguished for this purpose. Before there can be a particular kind of loss it should be determined that there is an actual loss. It may be conceded that if, under the formula here advocated, there is a loss, it would be a loss of capital; but it need not be conceded that a loss of capital in excess of actual loss should

be permitted. (However, the writer admits to some suspicion that, in most courts, the theory might founder upon this point.)

The next question is whether the theory would not apply with equal validity to private security transactions. It would; but there may be justification for difference in method of treatment if the final result is not essentially different. Take the case of a corporate $1,000, 4% bond purchased at par, held ten years and sold for $900. In the last year we allow a loss of $100. During the holding period, however, the taxpayer has received $400 in taxable interest. Since he has paid out $1,000 and has received back only $400 plus $900 or $1,300, we know that the entire transaction can represent only $300 profit. We have taxed him already on $400.[55] We tax him on interest annually because it is more convenient to do so and because it is conventionally considered "income" received within the year; but if we do not then allow the $100 loss we have taxed him on more than his actual profit on the entire transaction. This factor is definitely not present in the public security cases, because there nothing has been taxed. At the end of the transaction nothing will be taxed, because any net profit in the case put necessarily represents exempt interest; but neither is there any loss.

Suppose momentarily that interest on private securities were not taxed annually, but taxable profit or loss for each transaction were computed at its close. In the above illustration, we would arrive at a taxable profit for the final year of $300—the net result for all years under the present system. If the sale price had been $500, we would arrive at a net loss for the final year of $100, also the net result of the present system under which we would tax a total of $400 and allow a loss of $500. The net result of the two methods would always be the same in the case of private securities. If we could apply either to public securities, the results would likewise be the same; but there annual taxation of interest is prevented by the exemption granted, and the exemption likewise prevents taxation in the final year wherever the net profit does not exceed the amount properly regarded as interest.

In other words, while the suggestion could be applied to private security transactions, it would be unreasonable to do so unless we abandoned the annual taxation of interest from such securities. The absence of this factor in the public security field justifies the suggested difference in treatment. The difference between the two situations seems

[55] Concededly, because of personal exemptions or lack of other income, we may have actually collected tax on nothing at all. However, the personal situation of the taxpayer and variations in other income from year to year should not be allowed to confuse the problem. It should be resolved on the basis of the tax status of types of income or deductions, assuming that in each year involved the taxpayer has some taxable income.

just as substantial as that which has led to the difference in treatment of discounts as between public and private bonds.[56]

Assuming that the state authorities wished to adopt this proposal, would it be constitutional and, if so, could it be done under the present statute?

The various constitutional arguments which might be made, are very similar in character. As to Federal securities, the argument would be that it amounts to indirect taxation of exempt interest; that it discriminates against such securities; and that, even if no indirect taxation of interest or discrimination is involved, it is itself a direct burden on the borrowing power. As to state and local securities, the first two arguments might also be used (the first on the theory that to permit taxation of interest in such a way will violate the prohibition against impairment of contracts). None of the arguments seems valid.

It would not amount to indirect taxation of interest. The whole purpose of the rule is to determine how much, if any, *other income* can be offset, not how much of the total receipts from the transaction are taxable. It is conceded that if total receipts exceed the price paid, no part of such excess which represents interest can be taxed. The argument is really that there is indirect taxation of interest solely because the same deductions are not allowed as in the case of private securities. Thus it really amounts to the same idea as the discrimination argument.

Yet, while obviously there is a difference in the method of treatment, there is no legal discrimination. Wherever there is a reasonable factual difference the legal basis is laid for difference in method of treatment. There is such a factual difference here in that interest from private securities is taxed annually while that from public securities is not. When Congress provided that the taxpayer could not deduct interest paid on money borrowed to purchase tax exempt securities, it was likewise argued that the provision was discriminatory. However, the Supreme Court decided otherwise.[57] Further, it has been held that accrued tax-exempt interest cannot subsequently be charged off against other income as a bad debt.[58]

[56] It might be argued that, if this theory is sound, it should also be applied to determine deductibility of losses on those corporate stocks the dividends from which are not taxable to the stockholder. See §§311½ and 322(5), Ch. 158, N. C. Pub. L. 1939. However, this does not necessarily follow. Interest on public securities is exempt though it represents income which has never been taxed to any taxpayer. Corporate dividends are exempt to the stockholder only because the legislature regards them as representing income already taxed to the corporation. Since the dividend income has thus already been taxed, the stock stands in the position of private rather than public bonds.

[57] Denman v. Slayton, 282 U. S. 514, 51 Sup. Ct. 269, 75 L. ed. 500 (1931).

[58] District Bond Co. v. Commissioner, 113 F. (2d) 347 (C. C. A. 9th, 1940). *Cf.* the language of Mr. Justice Stone, dissenting, in National Life Ins. Co. v.

Finally, the result of the suggestion would not be to place a direct burden on the borrowing power (assuming that taxation of interest will continue to be judicially regarded as being an unconstitutional burden on such power). Possibly, if the suggestion were adopted for all state and Federal income taxes, it might have some very slight influence on the interest rates and saleability of government securities, though such influence would be trivial by comparison to such matters as the safety of the investment and the exemption of the interest. However, as long as there is no attempt by a state to tax anything connected with the borrowing transaction, there can be no direct burden, in the legal sense, on the borrowing power. Refusal to permit reduction of other taxable income, having nothing to do with public securities, should hardly be regarded as such a burden.

The conclusion is that there is nothing unconstitutional about the suggestion. Thus, if our statute expressly incorporated it, there would be no further question to be considered. Even if the suggestion be regarded as manifesting a regrettable failure to comprehend the simple distinction between income and capital, this could hardly render unconstitutional a statute which adopted it. The legislature must be conceded considerable discretion in refusing to allow deductions, even though they involve loss of capital; and this is particularly true where the loss grows out of a transaction which is, in part, tax-exempt.

However, since there is no express provision incorporating the suggestion in our statute, could it be followed by administrative authorities under the law as written? As already indicated, the only losses permitted as deductions by our statute are losses *actually* sustained in connection with a transaction entered into for profit. There is no reason why this should not be construed to mean what it says; and, if the above analysis is sound, there has been no actual loss. In determining gain or loss, the basis is cost (unless the security was acquired prior to January 1, 1921, and cost is not determinable). This requirement is completely satisfied, as the entire purchase price is considered in determining whether there was a loss.

Several accountants with whom the writer has talked have attacked the suggestion on the ground that, by taking account of interest payments over a period of years, it violates the statutory plan of breaking up the taxpayer's affairs into annual periods, each of which must be considered alone for tax purposes. This, however, seems to be an

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United States, 277 U. S. 508, 536, 48 Sup. Ct. 591, 599, 72 L. ed. 968, 978 (1928): "There is a distinction between imposing a burden and withholding a favor. By the Constitution or by contract the holders of tax-exempt securities are protected from burdens; but from neither source do they derive an affirmative claim to favors."

unsound objection. Obviously, for determination of gain or loss upon disposition of property the events of past years must always be considered. The annual period has importance only in determining when gain or loss is to be reported, not in determining the exact amount of gain or loss.

The writer is fully aware that his conclusions with regard to these theories are merely his own and that there is no assurance that either theory would receive judicial approval, particularly in view of Federal precedent. Because it is less drastic and interferes to a lesser extent with conventional notions about loss of capital as an item having nothing to do with annual "income", the chance for judicial approval, in the absence of express statutory provision, of the first or "amortization" theory would be very much greater than for approval of the second theory. In fact, administrative authorities might not be willing to attempt to follow where the latter would lead. They should, however, at least be willing to go as far as adoption of the first proposal.

It remains only to recognize that, to the extent that impending developments may result in eliminating exemptions for interest on public securities, the importance of the loss problem here discussed will be lessened, for to that extent those securities may be treated in the same way as private securities. However, as indicated in connection with the discussion of discounts, there is no reason to anticipate complete elimination of the problem in the immediate future.