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Income Tax -- Original Issue Discount

R. Walton McNairy Jr.

to sense the needs of the community with respect to the risks the community is willing to take.

What will result when *Rouse v. Cameron* is superimposed on this commitment-release scheme is unforeseeable. It seems unlikely that a court can force basic policy changes by the use of compulsory processes against the hospital authorities on a case by case basis. The money, personnel and facilities necessary for therapy are simply not available.[24] And an order to the director of St. Elizabeth's requiring him to provide individualized treatment for the entire patient population would clearly be beyond the realistic limits of judicial power. Unless there is legislative initiative, it seems that a court will be faced with the knowledge that the only way to realize results—as the experience of the U.S. Supreme Court with the exclusionary rule demonstrates—is to turn patients denied therapy loose on the community. Presumably, in individual cases, the court will make a determination of dangerousness, and go through some process of balancing the interests involved.

SAMUEL HOLLINGSWORTH, JR.

Income Tax—Original Issue Discount

In a never-articulated effort to prevent tax avoidance,[1] the courts have engrafted a number of judicial concepts on the statutory definition of capital assets in spite of the all-inclusive language used by Congress.[2] By far the most famous, or infamous, of these is the assignment of income doctrine[3] which had its true beginning in

[24] The opinion of the American Psychiatric Association is that no tax-supported institution in the United States can be considered adequately staffed. U.S. SURGEON GENERAL'S AD HOC COMMITTEE ON PLANNING FOR MENTAL HEALTH FACILITIES, PLANNING OF FACILITIES FOR MENTAL HEALTH SERVICES 39 (1961).

[1] Bowden, *Assignment of Income Reconsidered,* 20 TAXES 67 (1942).

[2] The Int. Rev. Code of 1954, § 1221, defines a capital asset as all property unless it falls within one of five specifically excluded groups. Some courts have limited the class of preferred capital gains property by straining to find an exclusionary category satisfied. See, *e.g.,* Hollis v. United States, 121 F. Supp 191 (N.D. Ohio 1954).

[3] See generally, Lyon & Eustice, *Assignment of Income,* 17 TAX L. REV. 293 (1962). Another equally clear area of judicial legislation was established by Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955). There the Court conceded that futures contracts which were "an integral part of its [the company's] business" did not come within the exclusionary clauses

Lucas v. Earl[4] in 1930. The doctrine itself totally escapes definition or delineation, but in general it can be divided into two broad areas of concern with underlying policies and distinctions that crisscross the whole field of income taxation. In donative transactions the theory is to tax the donor in order to prevent the spreading of income among the members of a group to take advantage of the lower tax rates.[5] In commercial transactions the theory is to tax the sale or exchange of an income right at ordinary income tax rates so as to limit the range of preferred capital gains treatment and prevent the erosion of the ordinary income tax base.[6] It is in this later category that most of the confusion has resulted.[7]

In *United States v. Midland-Ross Corp.*,[8] the Supreme Court was faced with conflicting opinions in the circuits as to the disallowance of capital gains treatment for earned original issue discount.[9] The taxpayer bought noninterest-bearing promissory notes from the issuers at prices discounted below face value, held the notes for more than six months, and sold them for a profit. The difference between purchase price and sale price was not influenced by market fluctuations; it was conceded to be the economic equivalent of interest. Two basic elements for the application of the assignment of income doctrine were present: the character of the gain as essentially equivalent to earned ordinary interest income, and the maturity or ripeness of the accrued economic gain.[10] These two factors taken together served to deny capital gain treatment.

of the capital asset definition, but still found that gains and losses on the sale of these contracts were ordinary gains and losses. The capital asset definition does not provide for a distinction between business property and investment property, but the Court excluded these contracts on the theory that the underlying purpose of capital asset treatment was to relieve investors from excessive hardships when they converted their investment into cash.

[4] 281 U.S. 111 (1930).

[5] Helvering v. Horst, 311 U.S. 112 (1940); Helvering v. Clifford, 309 U.S. 331 (1940); Lucas v. Earl, 281 U.S. 111 (1930).

[6] Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958); Hort v. Commissioner, 313 U.S. 28 (1941); Burnet v. Harmel, 287 U.S. 103 (1932).

[7] See generally, Del Cotto, *Property in the Capital Asset Definition: Influence of "Fruit and Tree."* 15 BUFFALO L. REV. 1 (1965); Note, *Capital Gains: Can the Confusion be Eliminated?*, 49 IOWA L. REV. 89 (1963); Note, *The Troubled Distinction Between Capital Gain and Ordinary Income*, 73 YALE L.J. 693 (1964).

[8] 381 U.S. 54 (1965).

[9] *Id.* at 56 n.2.

[10] The presence of these two factors in combination caused an ordinary income result upon the sale of a life insurance policy immediately prior to

Using its usual definitional approach,[11] the Court determined that earned original issue discount is but interest in another form[12] and is outside the judicial definition of a capital asset.[13] The gain on the transaction was measurable and predictable and represented simply the amount earned by the investment up to the time of sale rather than an appreciation in value over a period of time. The Court concluded that realization of this profit through the sale device was essentially a substitute for payments that would, if received in another manner, be characterized as ordinary income.[14] The Court relied heavily upon the cases holding that the present realization of future ordinary income, even though cast in the form of a sale, will be taxed at ordinary income rates.[15] This principle is appropriately applied only by analogy because in *Midland-Ross* there was no sale of future income; the income element there involved had already accrued. Despite the factual distinction, the Court was logically correct in its conclusion. Since the sale of a right to future ordinary income will result in ordinary gain,[16] a fortiori, if the right to such income has

its maturity despite an ostensible compliance with the statutory requirements. Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960).

[11] The Court relied upon its usual canon of construction that the term "capital asset" must be construed narrowly in order to afford capital gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time (citing Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130 (1960)) and to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income (citing Hort v. Commissioner, 313 U.S. 28 (1941) and Commissioner v. P. G. Lake, Inc., 365 U.S. 260 (1958)). 381 U.S. at 57.

[12] The Court illustrated the disguised interest component of original issue discount by stating, "The $6 earned on a one-year note for $106 issued for $100 is precisely like the $6 earned on a one-year loan of $100 at 6% stated interest." 381 U.S. at 58.

[13] Int. Rev. Code of 1954 § 1232(a)(2) provides that any portion of the gain attributable to original issue discount on notes or bonds issued after January 1, 1955 will be treated as ordinary income. The provision does not apply to pre-1955 notes as were involved in *Midland-Ross*.

[14] Hort v. Commissioner, 313 U.S. 28 (1941) first introduced the "substitute for ordinary income" phraseology. Since the market price of any asset represents anticipated future profits plus the discounted value of the proceeds expected upon resale, all gain on property transactions could be characterized as a substitute for ordinary income. Fortunately, the courts have not thus extended the substitute for ordinary income doctrine to its logical extreme. But compare Donald J. Jones, P-H TAX CT. MEM. ¶ 66-136 (1966).

[15] Commissioner v. Gillette Motor Transp., Inc., 364 U.S. 130 (1960); Commissioner v. P. G. Lake, Inc., 365 U.S. 260 (1958); Hort v. Commissioner, 313 U.S. 28 (1941).

[16] *Ibid.*

already matured, and the income has been earned, its sale will similarly result in ordinary income.

An auxiliary ground for the result reached in *Midland-Ross* is the principle that where both an income producing asset and the right to accrued income from that asset are sold together, the purchase price must be allocated between the two and only the former is a capital asset.[17] As the courts recognize, the capital gains section of the Internal Revenue Code makes no distinction between an income-producing asset and the income which it produces; a literal reading of the statute would make the entire gain on the sale of the notes in *Midland-Ross* capital gain.[18] But an increasing number of courts have recently been closely scrutinizing the factor of ripeness or maturity of a taxpayer's accrued economic gain,[19] and holding that the right to collect ordinary income from a capital asset is not transmuted into capital gain by a sale of the capital asset together with the right to receive the ordinary income. Clear examples of the application of this principle can be seen in the denial of capital asset status to the sale of a partnership interest where part of the price is attributable to accrued ordinary income,[20] the sale of a life insurance policy shortly before it matures,[21] the sale of stock upon which a dividend has accrued,[22] and the sale of an orange grove where part of the value is attributable to an unmatured annual crop.[23] In *Midland-Ross,* the Court expressly approved this view, stating that the amount received on sale or retirement of the discount note must be broken down into its component parts and a differentiation made depending upon the source of the proceeds.[24]

[17] Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962); Jaglom v. Commissioner, 303 F.2d 847 (2d Cir. 1962).

[18] Lubin v. Commissioner, 335 F.2d 209 (2d Cir. 1964); Jaglom v. Commissioner, 303 F.2d 847 (2d Cir. 1962).

[19] Increased interest in the factor of maturity is a result of taxpayers' recent attempts to avoid the "sale or exchange rule" denying capital gain treatment to the mere "collection" of a claim. Fairbanks v. United States, 306 U.S. 436 (1939); Ogilvie v. Commissioner, 216 F.2d 748 (6th Cir. 1954). See generally, Eustice, *Contract Rights, Capital Gain, and Assignment of Income—The Ferrer Case,* 20 TAX L. REV. 1, 20 (1964).

[20] Jaglom v. Commissioner, 303 F.2d. 847 (2d Cir. 1962); Tunnell v. United States, 259 F.2d 916 (3d Cir. 1958); United States v. Snow, 223 F.2d 103 (9th Cir. 1955); Helvering v. Smith, 90 F.2d 590 (2d Cir. 1937). The same result is now reached by Int. Rev. Code of 1954 §§ 741, 751.

[21] Phillips v. Commissioner, 275 F.2d 33 (4th Cir. 1960); Abram Nesbitt 2d, 43 T.C. 629 (1965); Boling Jones, Jr., 39 T.C. 404 (1962).

[22] Brundage v. United States, 275 F.2d 424 (7th Cir. 1960), *cert. denied,* 364 U.S. 831 (1961).

[23] Watson v. Commissioner, 345 U.S. 544 (1953).

[24] 381 U.S. at 65.

The holding of *Midland-Ross* is clearly sound. Since a gift of such income would be taxable to the donor,[25] it should follow that he cannot convert that income into capital gain through a sale or exchange. That Congress prefers such a result is evidenced by section 1232(a)(2) of the Internal Revenue Code which now expressly adopts the *Midland-Ross* result when there is an original issue discount. While obviously correct on its particular facts, the *Midland-Ross* decision is subject to misinterpretation unless a distinction is recognized between "original issue discount" which serves the function of stated interest, and "market discount" which reflects a true appreciation to capital.[26] Upon analysis of these latter gains, it becomes evident that they are not "essentially substitutes" for payments characterized as ordinary income under the gross income definition, but represent the normal appreciation in value of a capital asset due to market factors completely beyond the taxpayer's control. However, the Court specifically declined to pass upon the tax treatment of gains arising from "market discount" or attributable to fluctuations in the interest rate and market price of obligations where there has been a discount purchase.[27]

The recent decision of Donald B. Jones[28] overlooks the distinction between original issue discount and market discount, and hands down a theory which, if followed, would result in an ordinary income aspect to the sale of any item purchased at a discount. The taxpayer had purchased a contingent trust remainder in a specific dollar amount from a dealer as a speculative investment. Of course

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[25] Helvering v. Horst, 311 U.S. 112 (1940) necessarily requires that income already accrued and matured at the time of gift is taxable to the donor where the underlying obligation is not concurrently given. Rev. Rul. 275, 1958-1 CUM. BULL. 22 (gift of back interest coupons taxable to donor). Commissioner v. Anthony, 155 F.2d 980 (10th Cir. 1946). See generally Lyon & Eustice, *Assignment of Income,* 17 TAX L. REV. 293, 353-62 (1962).

[26] Market discount represents the fluctuation in price of an obligation due to market factors once it has passed out of the hands of the original holder, and, unlike original issue discount, has never been classified as interest income. The distinction is discussed in Lubin v. Commissioner, 335 F.2d 209 (2d Cir. 1964) and Ted Bolnick, 44 T.C. 245 (1965). As stated in United States v. Harrison, 304 F.2d 835, 838 (5th Cir. 1962):

> The gain realized from such a transaction (bond purchased in a depressed market later redeemed at par) is a form of capital appreciation that resembles the capital gain received when stock or real estate is purchased and later sold at a profit, in contrast to an original issue discount gain which represents the interest or compensation paid for the use of money loaned.

[27] 381 U.S. at 54 n.4.

[28] Donald J. Jones, P-H Tax Ct. Mem. 66-136 (1966).

the purchase was at a considerable discount because of the many risks involved. The Court of Appeals for the Third Circuit ignored the fact that the discount element was a product of the risks inherent in such a purchase and remanded to the Tax Court to determine what portion of the gain was attributable to interest income in the nature of "issue discount."[29] The Tax Court determined that the purchaser had received a six percent interest discount that would be taxable as ordinary income. The result gives the commissioner authority for asserting that in all discount purchases there is an imputed interest element which will not qualify for capital gains treatment. Such a theory would appear to be erroneous because it transposes the imputed interest factor from the deferred payment sales context[30] into the entirely distinct discount purchase context. Further, it results in the denial of capital gain treatment to the normal appreciation of an admitted capital asset due to market factors, and ignores the fact that the condemnation in *Midland-Ross* resulted because that discount was the economic equivalent of interest.

R. WALTON MCNAIRY, JR.

Labor Law—Effect of 9(c)3 on Duty to Bargain

The Labor Management Relations Act, section 9(c)3, prohibits holding a representation election in a bargaining unit "within which in the preceding twelve-month period, a valid election shall have been held."[1] The issue in *Conren, Inc. v. NLRB*[2] was whether this prohibition prevents enforcement of an order to bargain issued because of the employer's refusal, nine and one-half months after the union had lost an election, to grant recognition on the basis of authorization cards signed by a majority of his employees.

The Court of Appeals for the Seventh Circuit enforced the NLRB's order to bargain, with Circuit Judge Kiley dissenting. The majority reasoned that the affirmative reference to "election" in 9(c)3 should not be construed to preclude representation based

[29] Jones v. Commissioner, 330 F.2d 302 (3d Cir. 1964).
[30] Int. Rev. Code of 1954, § 483.

[1] 61 Stat. 143 (1947), 29 U.S.C. § 159(c)3 (1964).
[2] 368 F.2d 173 (7th Cir. 1966), *cert. denied*, 35 U.S.L. Week 3330 (U.S. Mar. 21, 1967).