

APPENDIX A

SOURCE OF ORIGINAL ISSUE DISCOUNT INCOME

Under sections 861(a)(1)(B) and 862(a)(1) of the Internal Revenue Code, the source of "interest" received from a domestic corporation may be either domestic or foreign. Interest paid by a domestic corporation constitutes income from sources without the United States if the corporation which paid it derived less than 20 percent of its gross income from United States sources during the three year period ending with the taxable year in which the interest was paid, or the lesser period since it was incorporated. Otherwise, interest paid by a domestic corporation constitutes income from sources within the United States. The purpose of this memorandum is to demonstrate that the source of original issue discount income is determined in the same manner as "interest".

1. UNDER CASE LAW AND RULINGS ORIGINAL ISSUE DISCOUNT
HAS BEEN EQUATED WITH INTEREST

Where a debt instrument provides for a fixed return upon the money loaned payable at regular intervals by the borrower, those payments are customarily referred to as "interest". Where some or all of the return is provided instead by a lesser amount of money being loaned than the principal amount payable at maturity, the difference between principal and the amount loaned constitutes "original issue discount".¹ Original issue discount thus performs the same function as stated interest by providing the lender a fixed return upon his loan.

The functional equivalence of interest and original issue discount for income tax purposes is inherent in the definitions of "interest" that have been employed for income tax purposes. For example, the Supreme Court has characterized "interest" as: "* * * the amount which one has contracted to pay for the use of borrowed money" and as: "* * * compensation for the use or forbearance of money." *Old Colony Railroad Company v. Commissioner*, 284 U.S. 552, 560 (1932); *Deputy v. du Pont*, 308 U.S. 488, 498 (1940).

Original issue discount clearly fulfills the function of "interest" as so defined.

Similarly, § 1.543-1(b)(2) of the Income Tax Regulations, describing personal holding company income, provides that:

"The term 'interest' means any amounts, includible in gross income, received for the use of money loaned".

See also Regulations § 1.856-2(c)(2)(ii), respecting real estate investment trusts, providing that "interest" includes "only the amount which constitutes lawful interest for the loan or forbearance of money."

Because original issue discount performs the same economic function as interest, it has consistently been held that absent a compelling reason (not present here) for differentiating between the two forms of income, earned original issue discount is governed by the same rules

¹ The term "original issue discount" as used in this memorandum is employed in the sense mentioned, except where the context indicates that the section 1232(b)(1) definition is intended. The principal difference in the two definitions is that section 1232(b)(1) excludes discount of less than $\frac{1}{4}\%$ a year.