

"* * * The profit of the taxpayers was realized by virtue of the fact that they lent the money in Germany to their local customers at a much higher rate of interest than the taxpayers were compelled to pay to the New York Bank." 115 F.2d at page 472.

The Court of Appeals decision in *Stein* stands for the same proposition as I.T. 2330. That is, that since original discount income is the functional equivalent of interest, the source of earned original issue discount is whatever would have been the source of stated interest were such interest paid by the obligor.

B. Authorities in Other Areas Treat Original Issue Discount Income the Same as Interest

1. Gain attributable to original issue discount constitutes ordinary income and not capital gain

The alternative to treating earned original issue discount as interest is to view the income as gain from the sale or exchange of property. If so viewed, sections 861(a)(1) and 862(a)(1) of the Code, dealing with the source of interest income, would not apply and source would be determined under the source rules pertaining to the sale of personal property. See Code Section 861(a)(6) and Rgs. § 861-7(a).

In *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965) and *Dixon v. United States* 381 U.S. 68 (1965) the Supreme Court considered in a different context this same question of whether original issue discount income should be taxed as interest or as gain from the sale of property. Both cases involved taxpayers who had purchased non-interest-bearing promissory notes from the issuers at prices below the face amounts of the notes and had sold the notes at a profit in a year prior to enactment of the provisions of section 1232 of the 1954 Code taxing earned original issue discount as ordinary income. The taxpayers claimed capital gains treatment under section 117(a) of the Internal Revenue Code of 1939, corresponding to section 1222 of the 1954 Code, which provided in part, that gain from the "sale or exchange of a capital asset" held for more than six months constitutes long-term capital gain.

The Court denied capital gains treatment in both instances, resting its opinion primarily upon the functional identity of original issue discount income and interest. It reasoned:

"Earned original issue discount serves the same function as stated interest, concededly ordinary income and not a capital asset; it is simply 'compensation for the use or forbearance of money.' *Deputy v. Du Pont*, 308 U.S. 488, 498; *cf. Lubin v. Commissioner*, 335 F.2d 209 (C.A. 2d Cir.) * * * 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. The application of general principles would indicate, therefore, that earned original issue discount, like stated interest, should be taxed under § 22(a) as ordinary income."³

United States v. Midland-Ross Corp., 381 U.S. at pp. 57-58.

³ In view of the decisions in *Midland-Ross* and *Dixon*, it may be desirable for the Service to reconsider O.D. 534, 2 C.B. 103. O.D. 534 held that (1) the collection at maturity by foreign corporations and nonresident alien individuals of British Treasury bills purchased by them in the United States at a discount constitutes income from sources outside the United States, whether collected in a foreign country or from a British paying agent in the United States, whereas (2) profit upon sale of the same bills in the United States constitutes United States source income. It is believed that the latter holding can be reconciled with *Midland-Ross* and *Dixon* only insofar as the profit is assumed to arise from appreciation of the securities due to a change in market conditions and cannot be reconciled insofar as the profit is attributable to the approach of the maturity date of the bills.