

Another recently enacted Code section also has an important bearing upon the proper characterization of original issue discount. Section 904(f) was added to the Code by section 10 of the Revenue Act of 1962 to prevent taxpayers whose foreign tax credits exceeded the allowable limitation under section 904 (prior to its amendment) from increasing the creditable amount by investing in foreign debt obligations. S. Report No. 1881, 87th Cong. 2d Sess., 1962-3 C.B. 707, 778 (1962). An underlying purpose of the section was to remove "an artificial inducement to the movement of U.S. capital abroad". 1962-3 C.B. at page 778.

Section 904(f) requires that in determining the limitation on credit a taxpayer compute separately, and without respect to the overall limitation, the amount of limitation on "interest income", as described in section 904(f)(2), and on all other income. "Interest" is not defined in the statute or committee reports, nor have proposed regulations under section 904(f) been promulgated.

Section 904(f) could be easily flouted if the Service were to conclude that the source of original issue discount were to be determined under rules respecting gain from the sale of property rather than the rules respecting interest. A taxpayer with excess foreign tax credits would then be free to increase its allowable foreign tax credit by purchasing indebtednesses issued by foreign corporations at a discount and either holding the obligations to maturity or selling them abroad before maturity. Assuming the gain was not taxed, or was only lightly taxed, by the foreign country, taxpayers in this manner would be able to increase their foreign tax credits allowable under section 904 notwithstanding enactment of section 904(f).⁵

For the reasons stated above, it seems clear that the source of original issue discount income in any case is the same as the source of stated interest paid by the obligor on the discount instrument under the rules of section 861(a)(1)(B) and 862(a)(1) of the Internal Revenue Code.

DAWSON, GRIFFIN, PICKENS & RIDDELL,
Washington, D.C., February 11, 1966.

MEMORANDUM

To: HON. WILBUR D. MILLS, *Chairman,*
Committee on Ways and Means, U.S. House of Representatives.
From: JAMES W. RIDDELL.
Re Europe—Dollar companies and section 904(f).

Many U.S. corporations are confronted with the necessity for foreign expansion and have been unable to do so because of the balance-of-payments problem. Several U.S. taxpayers have obtained the

⁵ If earned original issue discount were not treated as interest for source of income purposes, taxpayers might also be able to increase their section 904 limitation by purchasing obligations of domestic obligors at a discount and selling the obligations abroad before maturity. Whether they would be successful would depend upon whether the court chose to follow such decisions as *Commissioner v. Phillips*, 275 F. 2d 33 (4th Cir. 1960, rev'g, 30 T.C. 866 (1958)), and *Arnfeld v. Commissioner*, 163 F. Supp. 865 (Court of Claims 1958), *cert. den.* 359 U.S. 943, holding that sales of endowment policies shortly before maturity produced ordinary income, or followed the line of cases typified by *Barber-Green Americas, Inc.*, 35 T.C. 365 (1960), acq. 1961-2 C.B. 4, 1964-2 C.B. 4, which refused to apply a "tax avoidance" exception to the rule that sales income is realized in the country where title to the property sold passes. See Regs. § 1.861-7(a). It would seem likely that where the discount obligations were sold abroad well before their maturity date, the latter cases would control and the gain would constitute foreign source income.