

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 6, 1999

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Index (UIL) No.:1278.00-00  
CASE MIS No.:TAM-121763-98

Number: **199928003**  
Release Date: 7/16/1999

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference:

**LEGEND:**

Corporation X =  
Corporation Y =  
Corporation Z =

**ISSUE:**

Whether gains recognized when "grandfathered" market discount bonds are called for redemption are gains recognized on "redemption at maturity" within the meaning of section 1011(d) of the Tax Reform Act of 1986 (TRA '86), P.L. 99-514, 1986-3 (Vol. 1) C.B. 307.

**CONCLUSION:**

Gains recognized when "grandfathered" market discount bonds are called for redemption are not gains recognized on "redemption at maturity" within the meaning of section 1011(d) of TRA '86.

**FACTS:**

Taxpayer files its return as a life insurance company (as defined in section 816 of the Internal Revenue Code) subject to the tax imposed by section 801. Prior to September 26, 1985, Taxpayer purchased, at a market discount, certain bonds issued

prior to July 19, 1984 (the market discount bonds). The market discount bonds were acquired by Taxpayer to meet its future benefit obligations.

Each market discount bond could be repurchased by its issuer before the stated due date. Corporation X bonds, for example, were due March 1, 2005, but could “be redeemed by [X] as a whole at any time or in part from time to time prior to the maturity thereof by payment of” the principal amounts plus a premium. Similarly, Corporation Y Bonds, due on June 15, 2010, could be “redeemed at the option of [Y] as a whole, or from time to time in part, on any date prior to maturity” and Corporation Z Bonds, due on March 15, 2000, could be “redeemed at the option of [Z] as a whole, or from time to time in part, on any date prior to maturity.” During the taxable years involved, the market discount bonds were called for redemption by their respective issuers.

## **LAW AND ANALYSIS**

The Deficit Reduction Act of 1984 (the 1984 Act), P.L. 98-369, 1984-1 (Vol. 1) C.B. 1, generally required “the market discount accrued on disposition of a bond” to be treated as ordinary income rather than as capital gain (section 1276 of the Code). Bonds issued before July 19, 1984, however, were grandfathered. Income attributable to market discount on these bonds would still qualify for capital gain treatment.

Prior to the TRA '86, corporations could take advantage of an alternative tax rate for net capital gains. Specifically, if it produced a lower tax, net capital gains were subject to a 28 percent rate rather than the regular, graduated corporate rates. Subtitle B of title III of TRA '86 effectively removed this advantage by setting the alternative tax rate at the highest corporate rate (34 percent).

Section 1011(d)(1) of TRA '86 provides a special transition rule which restored the 28 percent alternative rate with respect to gain attributable to market discount on previously grandfathered bonds. The statute provides that:

Notwithstanding the amendments made by subtitle B of title III [of TRA '86], any gain recognized by a qualified life insurance company on the redemption at maturity of any bond which was issued before July 19, 1984, and acquired by such company on or before September 25, 1985, shall be subject to tax at the rate of 28 percent.

Section 1011(d)(2) of TRA '86 explains that a “qualified life insurance company” is one of 15 specifically named companies. There is no legislative history explaining either section 1011(d)(1) or 1011(d)(2).

Section 1010 of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), P.L. 100-647, 1988-3 C.B. 110-111, modifies the special transition rule by: (1) explicitly limiting it to market discount bonds (as defined in section 1278 of the

Code); (2) changing the maximum tax rate applicable to gains from 28 percent to 31.6 percent; and (3) extending it to all life insurance companies. As modified the special transition rule (section 1011(d)(1) of TRA '86) states that:

Notwithstanding the amendments made by subtitle B of title III [of TRA '86], any gain recognized by a qualified life insurance company on the redemption at maturity of any market discount bond (as defined in section 1278 of the Internal Revenue Code of 1986) which was issued before July 19, 1984, and acquired by such company on or before September 25, 1985, shall be subject to tax at the rate of 31.6 percent. The preceding sentence shall apply only if the tax determined under the preceding sentence is less than the tax which would otherwise be imposed.

In explaining the modified transition rule, H. Rep. No. 795, 100<sup>th</sup> Cong. 2d Sess. 113 (1988) and S. Rep. No. 445, 100<sup>th</sup> Cong. 2d Sess 119 (1988), make the following statement regarding then present law:

Under the [TRA '86] a special rule is provided for gain with respect to certain bonds of certain specified life insurance companies. Pursuant to this rule, gain representing market discount recognized by such companies on the redemption at maturity of any bond which was issued before July 19, 1984, and acquired by the company on or before September 25, 1985, is subject to tax at the rate of 28 percent. Market discount recognized by such companies on any other disposition of such bonds is subject to tax at regular rates.

Resolving the issue presented turns on the meaning of the phrase "redemption at maturity" as used in the transition rule. Taxpayer maintains that an issuer's repurchase of a market discount bond before the stated due date is a "redemption at maturity" entitling the taxpayer to apply the special 31.6 percent tax rate to the resulting net gains. According to Taxpayer, the meaning of the word "maturity" under commercial law includes an issuer's call. The phrase "redemption at maturity," therefore, must also include a call.

Taxpayer's arguments are unpersuasive because the phrase "redemption at maturity" has a commonly understood meaning in commercial law as redemption at the "stated" maturity date of a debt instrument. Hence, since there is no ambiguity in the words chosen by Congress in the transition rule, parsing the phrase "redemption at maturity" to glean a different meaning from its component parts is unwarranted. See, Norfolk Southern Corporation and Affiliated Companies v. Commissioner, 104 T.C. 13, at 40 (1995) (The meaning of words in a statute ordinarily is derived from their context ... Therefore, in interpreting the meaning of [a provision] we do not focus on one word as petitioners have done, for to do so runs the risk of distorting the statute's true meaning).

Financial dictionaries, when defining the word “redemption” routinely use words such as “at maturity” and “upon maturity” to refer to repurchase of an instrument at the stated due date, and words such as “before maturity” and “prior to maturity” to refer to repurchase before the stated due date. For example, Barron’s Dictionary of Finance and Investment Terms 358 (3<sup>rd</sup> ed. 1991) defines redemption as “repayment of a debt or preferred stock issue, at or before maturity, at par or at a premium price,” the Dictionary of Banking 288 (1993) defines redemption as “(1) the liquidation of an indebtedness, on or before maturity, such as the retirement of a bond issue prior to its maturity date,” and the Bank Administration Institute’s Dictionary of Banking 194 (1989) defines redemption as “liquidation of an indebtedness; whether at or prior to maturity, such as the retirement of a bond issue before its maturity date.”

Similarly, the Encyclopedia of Banking & Finance 981 (10<sup>th</sup> ed. 1994) defines redemption as “[t]he act of redeeming a debt: payment of a debt: retirement of an issue of bonds or notes; the cancellation of a debt, whether on a date prior to maturity or upon the date of obligatory maturity,” and Wall Street Words The Basics and Beyond 55 (1991), explains that “[r]edemption can be made before or at maturity depending upon call privileges.” Accordingly, when Congress used the phrase “redemption at maturity” in the relief provision, the clear meaning of the phrase was redemption at the stated maturity date.

Moreover, the courts have used the phrases “redemption at maturity” and “redemption before maturity” to distinguish between bonds repaid at their stated due date and bonds repaid earlier. Cf., for example, Fairbanks v. United States, 306 U.S. 436 (1939), 1939-1 C.B. 260, aff’g 95 F.2d 794 (9<sup>th</sup> Cir 1938), (the Supreme Court described bonds repaid before the stated due date as redeemed before maturity); Bolnick v. Comm., 44 T.C. 245 (1965), (bond redeemed before due and payable date referred to as “redemption . . . by the issuers prior to maturity”); Schwartz v. Comm., 40 T.C. 191 (1963), (redemption of bond at stated due date referred to as “redemption at maturity”); Thomson v. Comm., 40 B.T.A. 60 at 61 (1939), (whether predecessor of section 1271 applied to purchase by issuer in bankruptcy because “the word ‘retirement’ was intended to mean redemption at maturity or at some earlier time, in accordance with the terms of the debentures”); Bank of Lexington v. Vining-Sparks Securities, 959 F. 2d 606, 611 (6<sup>th</sup> Cir. 1992) (bond brokers must disclose “the interest rate, maturity date, and if the securities are subject to redemption prior to maturity (callable)”); Illinois Terminal Railroad v. United States, 375 F. 2d 1016, 1018 (Ct. Cl. 1967) (municipal bond law “provided for their redemption prior to maturity upon certain conditions without the approval of the bond holders”).

The Service also has recognized that the phrase “redemption at maturity” commonly refers to redemption occurring at the stated maturity date, and is distinguishable from redemptions prior to that date. This is illustrated in Rev. Rul. 60-37, 1960-1 C.B. 309, which discusses the preservation of original issue discount in the case of bonds exchanged in the course of a reorganization. Before its reorganization, a

corporation had issued the taxpayer noninterest-bearing debentures at a cost of 20x dollars. These debentures were “redeemable at stated intervals prior to maturity at varying prices and [had] a value at maturity of 30x dollars.” As part of its reorganization, the corporation issued, in exchange for the old debentures, new ten year debentures having a principal amount of 30x dollars. In discussing the consequences to the taxpayer, the revenue ruling explains, inter alia, that:

[W]here the new debentures are redeemed at maturity, that part of the redemption value which represents the original issue discount constitutes interest and is taxable as ordinary income. To the same effect, where the new debentures are redeemed prior to maturity, that part of the redemption value which represents the original issue discount also constitutes interest and is taxable as ordinary income.

See also Rev. Rul. 74-172, 1974-1 C.B. 178, (“amounts paid by X to its debenture holders which represent premium payable by reason of redemption prior to maturity” were not interest for purposes of an income tax convention between the Netherlands and the United States).

Finally, there is the language of the bonds of Corporations X, Y, and Z, each of which refers to redemption before the stated due date as “redemption prior to maturity.” Although this language is not dispositive as to the statutory meaning of “redemption at maturity,” it certainly attests to the commonly understood meaning of that phrase “redemption at maturity” as something different and distinct from “redemption before maturity.”

Even were we to focus, as taxpayer has, on the word “maturity” despite the admonition of the courts, supra, we are not convinced that its meaning necessarily includes redemption before the stated due date. By itself, “maturity” is often used as a short-hand reference to a bond’s stated due date. This is apparent not only from the materials cited above, but also from various Code provisions.

Section 171(b)(1)(B)(i), for example, explains that in the case of a bond acquired before January 1, 1958, the amount of premium is determined “with reference to the amount payable on maturity or on earlier call date.” Similarly, section 171(b)(1)(B)(ii) provides that in the case of a bond acquired after December 31, 1957, the amount of premium is determined “with reference to the amount payable on maturity (or if it results in a smaller amortizable bond premium attributable to the period to earlier call date, with reference to the amount payable on earlier call date) . . . .” See also section 171(b)(2).

Additionally, section 6049, added by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), provides that “original issue discount on any obligation shall be reported . . . if section 1272 does not apply to the obligation, at maturity (or, if earlier, on

redemption).” This language clearly distinguishes maturity at the stated due date of the debt instrument from redemption. Moreover, the legislative history accompanying section 6049(b)(6)(A)(ii) repeatedly adopts similar language. S. Rep. No. 494, 97<sup>th</sup> Cong. 2d Sess. 240 (1982), and H. Conf. Rep. 760, 97<sup>th</sup> Cong. 2d Sess. 562 (1982). See also Rev. Rul. 85-119, 1985-2 C.B. 60 (Corporate issuer of Notes obligated itself to exchange its stock for the Notes “at maturity or at an earlier redemption date.”), and Rev. Rul. 58-210, 1958-1 C.B. 523 (Savings bonds “mature December 15, 1972, but may be redeemed, at the option of the United States, on and after December 15, 1967...”).

As the authorities supra, attest, the phrase “redemption at maturity” is neither vague nor ambiguous, but rather has a commonly understood meaning -- repurchase by the issuer at the stated due date. Our research has revealed that the Congress which enacted the provision wrote absolutely nothing concerning this rule, in what is otherwise a voluminous history with respect to TRA’86. There are no committee reports, colloquies or staff reports that discuss the provision. Our authority extends, therefore, solely to giving proper weight to the words as written by Congress.

For the reasons set out above, we conclude that relief under the transition rule is restricted to redemptions occurring at the stated due date.

### **CAVEAT**

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.