

Appeal of Norbert R. and Joan M. Lamoreaux

During 1980 and 1981, appellants purchased non-interest bearing United States Treasury obligations issued at a discount. Sale of these obligations resulted in losses to appellants of \$128,094 in 1980 and \$107,468 in 1981. Appellants took these losses as ordinary loss deductions on their returns for those years. Respondent disallowed the deductions as ordinary losses, allowed them as capital losses, and after recomputing appellants' taxes for the appeal years, issued notices of proposed assessment. Appellants protested. Respondent affirmed its action. This appeal followed.

Appellants argue here that non-interest bearing U.S. Treasury obligations are by their very nature **non-**capital assets so that gains or losses realized from sales of such obligations are recognizable as ordinary gains and losses rather than as capital gains and losses.

The term "capital asset" is a term defined by section 18161 of the Revenue and Taxation Code. That definition includes all property held by the taxpayer except for certain types of excluded property described by the section. The several types of excluded property described by the section do not include such property as non-interest bearing obligations of the United States Treasury.

We note that section **1221** of the Internal Revenue Code of 1954 defines "capital assets" for the purposes of the federal income tax. The general structure of section 1221 is similar to section 18161. But at one time, subsection **1221(5)** excluded from "capital **assets**" for federal purposes:

an obligation. of the United States or any of its possessions, or of a State or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue . . .

That exclusion was repealed and the repeal was applicable to property acquired or positions established after June 23, 1981, in tax years ending after June 23, 1981.

No similar exclusion for obligations of the United States was ever contained in section 18161's definition of "capital asset." Some cases have concluded that on non-interest bearing notes, the earned original

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issue discount that serves the same function as interest must, like stated interest on interest bearing notes, be taxed as ordinary income rather than as capital gain. But that conclusion does not rest on a separate conclusion that the principal of the note is not a capital asset. (Cf. United States v. Midland-Ross Corp., 381 U.S. 54 [14 L.Ed.2d 214] (1965).) Accordingly, we can only conclude that the obligations of the United States in question were and are capital assets for the purposes of California's Personal Income Tax Law, and losses realized on the sale of such obligations are capital losses for the purposes of the Personal Income Tax Law.

For those reasons, we must sustain the action of the respondent.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of **Norbert** R. and **Joan M. Lamoreaux** against proposed assessments of additional personal income tax in the amounts of \$8,974 and \$1,070 for the years 1980 and 1981, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this **6th day** Of May , 1986, by the State Board of Equalization, with Board **Members** Mr. Nevins, Mr. Collis, Mr. Bennett, **Mr. Dronenburg** and **Mr. Harvey** present.

Richard Nevins , Chairman
Conway H. Collis , Member
William M. Bennett , Member
Ernest J. Dronenburg, Jr. , Member
Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9