**8553. Can the redemption of a debt obligation result in capital gains treatment?**

Redemption of a debt obligation can result in recognition of gain or loss in situations where the obligation was acquired at a premium or discount. The relevant issue for determining whether the retirement or satisfaction of the debt can result in a capital gain or loss is whether a sale or exchange has taken place. Historically, cases dealing with the subject found that no sale or exchange takes place when the maker of a debt satisfies the obligations under the debt instrument.[[1]](#footnote-1) IRC Section 1271 was enacted to change this result in many situations involving the redemption of debt obligations.

Under Section 1271, amounts received by the holder when the debt instrument is redeemed are treated as having been received in an exchange.[[2]](#footnote-2) Because of this, gain or loss realized upon redemption can qualify for capital gains treatment.

However, some debt instruments contain “original issue discount” which is a type of interest. This would be a debt instrument in which the maturity price exceeds the purchase price. The difference is the interest component.

*Example*. Asher purchases an original issue discount debt for $1,000 that matures two years later for $1,250. The difference between the maturity amount and the purchase amount, $250, is essentially interest.

Original issue discount interest is reportable as ordinary income. Such ordinary income may be realized, however, in some transactions where there was an intention to call the obligation before maturity at the time the obligation was originally issued.[[3]](#footnote-3) If this is the case, any gain realized in the transaction must be treated as ordinary income to the extent that the amount of gain does not exceed the sum of (a) the original issue discount, reduced by (b) the portion of original issue discount previously included in the gross income of any holder of the obligation.[[4]](#footnote-4)

The requirement that ordinary income be recognized does not apply to certain tax-exempt obligations and to holders who purchased the debt instrument at a premium.[[5]](#footnote-5)

1. . See, for example, *Wood v. Commissioner*, 25 TC 468 (1955). [↑](#footnote-ref-1)
2. . IRC Sec. 1271(a)(1). [↑](#footnote-ref-2)
3. . IRC Sec. 1271(a)(2)(A). [↑](#footnote-ref-3)
4. . IRC Sec. 1271(a)(2). [↑](#footnote-ref-4)
5. . IRC Sec. 1271(a)(2)(B). [↑](#footnote-ref-5)