

treatment is a “capital asset”, or treated as a “capital asset”. For definition of such assets, see sections 1221 and 1231, and the regulations thereunder. For some of the rules either granting or denying this special treatment, see the following sections and the regulations thereunder:

- (1) Transactions between partner and partnership, section 707;
- (2) Sale or exchange of property used in the trade or business and involuntary conversions, section 1231;
- (3) Payment of bonds and other evidences of indebtedness, section 1232;
- (4) Gains and losses from short sales, section 1233;
- (5) Options to buy or sell, section 1234;
- (6) Sale or exchange of patents, section 1235;
- (7) Securities sold by dealers in securities, section 1236;
- (8) Real property subdivided for sale, section 1237;
- (9) Amortization in excess of depreciation, section 1238;
- (10) Gain from sale of certain property between spouses or between an individual and a controlled corporation, section 1239;
- (11) Taxability to employee of termination payments, section 1240.

§ 1.61-7 Interest.

(a) *In general.* As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. Interest income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, a promissory note, a mortgage, or a corporate bond or debenture; the interest portion of a condemnation award; usurious interest (unless by State law it is automatically converted to a payment on the principal); interest on legacies; interest on life insurance proceeds held under an agreement to pay interest thereon; and interest on refunds of Federal taxes. For rules determining the taxable year in which interest, including interest accrued or constructively received, is included in gross income, see section 451 and the regulations thereunder. For the inclusion of interest in income for the purpose of the retirement income credit, see sec-

tion 37 and the regulations thereunder. For credit of tax withheld at source on interest on tax-free covenant bonds, see section 32 and the regulations thereunder. For rules relating to interest on certain deferred payments, see section 483 and the regulations thereunder.

(b) *Interest on Government obligations—(1) Wholly tax-exempt interest.* Interest upon the obligations of a State, Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia, is wholly exempt from tax. Interest on certain United States obligations issued before March 1, 1941, is exempt from tax to the extent provided in the acts of Congress authorizing the various issues. See section 103 and the regulations thereunder.

(2) *Partially tax-exempt interest.* Interest earned on certain United States obligations is partly tax exempt and partly taxable. For example, the interest on United States Treasury bonds issued before March 1, 1941, to the extent that the principal of such bonds exceeds \$5,000, is exempt from normal tax but is subject to surtax. See sections 35 and 103, and the regulations thereunder.

(3) *Fully taxable interest.* In general, interest on United States obligations issued on or after March 1, 1941, and obligations issued by any agency or instrumentality of the United States after that date, is fully taxable; but see section 103 and the regulations thereunder. A taxpayer using the cash receipts and disbursements method of accounting who owns United States savings bonds issued at a discount has an election as to when he will report the interest; see section 454 and the regulations thereunder.

(c) *Obligations bought at a discount; bonds bought when interest defaulted or accrued.* When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest, except as otherwise provided by law. See also paragraph (b) of this section for the rules relating to Government bonds. If a taxpayer purchases bonds when interest has been defaulted or when the interest has accrued but has not been

paid, any interest which is in arrears but has accrued at the time of purchase is not income and is not taxable as interest if subsequently paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued (depending on the method of accounting used by the taxpayer).

(d) *Bonds sold between interest dates; amounts received in excess of original issue discount; interest on life insurance.* When bonds are sold between interest dates, part of the sales price represents interest accrued to the date of the sale and must be reported as interest income. Amounts received in excess of the original issue discount upon the retirement or sale of a bond or other evidence of indebtedness may under some circumstances constitute capital gain instead of ordinary income. See section 1232 and the regulations thereunder. Interest payments on amounts payable as employees' death benefits (whether or not section 101(b) applies thereto) and on the proceeds of life insurance policies payable by reason of the insured's death constitute gross income under some circumstances. See section 101 and the regulations thereunder for details. Where accrued interest on unwithdrawn insurance policy dividends is credited annually and is subject to withdrawal annually by the taxpayer, such interest credits constitute gross income to such taxpayer as of the year of credit. However, if under the terms of the insurance policy the interest on unwithdrawn policy dividends is subject to withdrawal only on the anniversary date of the policy (or some other date specified therein), then such interest shall constitute gross income to the taxpayer for the taxable year in which such anniversary date (or other specified date) falls.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6723, 29 FR 5342, Apr. 21, 1964; T.D. 6873, 31 FR 941, Jan. 25, 1966]

§ 1.61-8 Rents and royalties.

(a) *In general.* Gross income includes rentals received or accrued for the occupancy of real estate or the use of personal property. For the inclusion of rents in income for the purpose of the

retirement income credit, see section 37 and the regulations thereunder. Gross income includes royalties. Royalties may be received from books, stories, plays, copyrights, trademarks, formulas, patents, and from the exploitation of natural resources, such as coal, gas, oil, copper, or timber. Payments received as a result of the transfer of patent rights may under some circumstances constitute capital gain instead of ordinary income. See section 1235 and the regulations thereunder. For special rules for certain income from natural resources, see Subchapter I (section 611 and following), Chapter 1 of the Code, and the regulations thereunder.

(b) *Advance rentals; cancellation payments.* Except as provided in section 467 and the regulations thereunder, gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. An amount received by a lessor from a lessee for cancelling a lease constitutes gross income for the year in which it is received, since it is essentially a substitute for rental payments. As to amounts received by a lessee for the cancellation of a lease, see section 1241 and the regulations thereunder.

(c) *Expenditures by lessee.* As a general rule, if a lessee pays any of the expenses of his lessor such payments are additional rental income of the lessor. If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor. Whether or not improvements made by a lessee result in rental income to the lessor in a particular case depends upon the intention of the parties, which may be indicated either by the terms of the lease or by the surrounding circumstances. For the exclusion from gross income of income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by a lessee, see section 109 and the regulations thereunder. For the exclusion from gross income of a lessor corporation of certain of its income taxes on