Internal Revenue Service

Number: **200525001**
Release Date: 6/24/2005
Index Number: 263.07-00, 446.00-00, 1272.01-04

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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, ID No.

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PLR-116977-04

Date:
March 11, 2005

Legend

Taxpayer =

Dear :

This is in response to Taxpayer's letter dated March 25, 2004, and subsequent correspondence, requesting a ruling on the term to be used to allocate debt issuance costs for purposes of '1.446-5 of the Income Tax Regulations in the case of callable debt that bears interest at a step rate.

FACTS

Taxpayer generally funds its business operations through the issuance of debt securities to the public. Taxpayer regularly issues short-term debt and long-term (callable and non-callable) debt. The rates of interest on the debt issued by Taxpayer include fixed rates, variable rates, and step rates (that is, fixed rates that are different during different periods over the stated term of the debt). In issuing its debt, Taxpayer incurs "debt issuance costs" within the meaning of §1.446-5.

In 2004, Taxpayer issued a number of debt securities that provide for stated interest at a step rate; the debt generally also is subject to one or more call options. For example, Taxpayer issued debt with a stated term of 5 1/2 years. However, the debt is redeemable at the option of Taxpayer beginning on or after the one-year anniversary date of the debt's issue date for an amount equal to the debt's stated principal amount plus accrued interest. The debt provides for stated interest at a step rate in which the interest rate increases each year the debt would be outstanding. Taxpayer represents that, under §1.1272-1(c), the term of the debt is one year (exercise of the call option on the one-year anniversary date would minimize Taxpayer's yield). However, Taxpayer represents that, if the rules under §1.1272-1(c) were to be applied by using the issue price determined under §1.446-5(b), the term of the debt would be two years (exercise of the call option on the second-year anniversary date would minimize Taxpayer's yield).

LAW

Section 1.446-5 provides rules for allocating debt issuance costs over the term of the debt for which the costs were incurred. The term debt issuance costs means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under §1.263(a)-5. If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under §1.446-5(b).

Under §1.446-5(b), solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, debt issuance costs are treated as if they adjusted the yield on the debt. To effect this adjustment, the issuer treats the costs as if they decreased the issue price of the debt. See §1.1273-2 to determine the issue price of a debt instrument. Thus, debt issuance costs increase or create original issue discount and decrease or eliminate bond issuance premium.

Under §1.446-5(b)(2), any resulting original issue discount is taken into account by the issuer under the rules in §1.163-7, which generally require the use of a constant yield method (as described in §1.1272-1) to compute how much original issue discount is deductible for a period. However, see §1.163-7(b) for special rules that apply if the total original issue discount on the debt is de minimis. Under §1.446-5(b)(3), any remaining bond issuance premium is taken into account by the issuer under the rules of §1.163-13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

Section 1.446-5 applies to debt issuance costs paid or incurred for debt instruments issued on or after December 31, 2003.

Section 1.1272-1(c) provides rules to determine the yield and maturity of certain debt instruments that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). For example, under §1.1272-1(c)(5), if a debt instrument provides for certain call options, the issuer is deemed to exercise or not exercise the options in a manner that minimizes the yield on the instrument.

RULING

Based on the information and representations submitted by Taxpayer, in the case of its callable debt that bears interest at a step rate, Taxpayer must use the term of the debt as determined under §1.1272-1(c) (determined without regard to the decreased issue price computed under §1.446-5(b)(1)) to allocate the debt issuance costs related to the debt for purposes of §1.446-5.

This ruling is directed only to the taxpayer that requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

Except as specifically set forth above, no opinion is expressed regarding the federal tax consequences of the transactions described above under any other provisions of the Code or regulations. For example, no opinion is expressed regarding whether Taxpayer's determinations under §1.1272-1(c) are affected by other provisions of the original issue discount regulations.

A copy of this letter ruling should be attached to Taxpayer's federal income tax return for the appropriate year.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

William E. Blanchard
Senior Technician Reviewer, Branch 3
(Financial Institutions & Products)

enclosure:

section 6110 copy

CC: