

Part I

Section 163.--Interest

26 CFR 1.163-1: Interest deduction in general.
(Also § 7805(b)(8); 301.7805-1.)

Rev. Rul. 2003-97

ISSUE

Under the facts presented below, if a corporation issues units, each consisting of instruments in the form of a 5-year note and a 3-year forward contract to purchase a quantity of the corporation's common stock, is the "interest" accruing on the note deductible under § 163(a) of the Internal Revenue Code and not disallowed under § 163(l)?

FACTS

On August 18, 2003 ("Issue Date"), X, a corporation, issues units, each consisting of instruments in the form of a 3-year forward contract to purchase a quantity of X's common stock ("Purchase Contract") and a 5-year note issued by X ("Note") (together, a "Purchase-Contract/Note unit"). The Purchase Contract requires the holder to purchase, and X to sell, on August 18, 2006 ("Settlement Date"), a quantity of X's common stock that is determined by reference to the market price of the stock on the Settlement Date.

The Note has a stated maturity date of August 18, 2008 ("Maturity Date"). Under the Purchase Contract, on the Settlement Date the holder must pay an amount ("Settlement Price") that is equal to the stated principal amount of the Note. If the market price of X's common stock on the Settlement Date falls within a specific range of market prices (bounded by a "lower limit" based on the market price on the Issue Date and an "upper limit" equal to approximately 120 percent of the lower limit), the quantity of stock deliverable under the Purchase Contract will have a market value equal to the Settlement Price. If the market price on the Settlement Date is less than the lower limit or greater than the upper limit, the quantity of stock that is deliverable under the Purchase Contract is the quantity that would be deliverable if the market price on that date were equal to the lower limit or the upper limit, respectively.

X allocates the purchase price of a Purchase-Contract/Note unit between the Purchase Contract and the Note according to their respective fair market values, as if the Purchase Contract and the Note were separate instruments. The amount allocated to the Note is equal to the Note's stated principal amount.

The Note contained in a Purchase-Contract/Note unit is pledged to secure the holder's obligation to pay the Settlement Price under the Purchase Contract. As described below,

the holder, however, has the legal right to separate the Note from the Purchase-Contract/Note unit in either of two ways (producing a "Separated Note"). The holder is not economically compelled to keep a unit unseparated.

The holder may separate the Note from the Purchase-Contract/Note unit before the Settlement Date without paying the Settlement Price. To do so, the holder must transfer the unit to X's agent ("Purchase Contract Agent") together with a specific zero-coupon Treasury security ("Strip"), and then the holder will receive a "Purchase-Contract/Strip unit" together with the Separated Note (a "conversion"). The Strip contained in the Purchase-Contract/Strip unit replaces the Note as collateral. Once a holder has effected a conversion, the holder may transfer the Note and retain the Purchase-Contract/Strip unit or transfer the Purchase-Contract/Strip unit and retain the Note. The Strips mature shortly before the Settlement Date and pay an amount equal to the Settlement Price. On the Settlement Date, X will apply the proceeds from the Strip contained in any Purchase-Contract/Strip unit to satisfy the holder's obligation to pay the Settlement Price under the associated Purchase Contract.

In addition, before the completion of a successful remarketing (described below), the holder of a Purchase-Contract/Note unit or a Purchase-Contract/Strip unit may transfer the unit to the Purchase Contract Agent together with cash in an amount equal to the Settlement Price and receive a quantity of shares of X's common stock together with the Separated Note or the Strip (a "settlement with separate cash").

The Note provides for quarterly payments of amounts denominated as interest, including a payment on the Settlement Date. This interest is payable at a single fixed rate ("Initial Rate"). The Notes are required to be remarketed on specific dates before the Settlement Date, including May 15, 2006, and August 15, 2006 ("Final Remarketing Date"). A successful remarketing of the Notes generally will result in the sale of the Notes to new holders effective on the next quarterly interest payment date (for example, May 18, 2006, and August 18, 2006) and will establish a new interest rate ("Reset Rate"), which will be effective after the remarketing for the remaining term of the Notes.

The Note is not subject to optional redemption by X at any time. Neither the written terms of the Note nor any other understanding or agreement requires the Note to be paid in, or converted into, X's stock. Similarly, neither the written terms of the Note nor any other understanding or agreement grants X an option to pay the Note in, or convert the Note into, X's stock.

X enters into a contract with an investment bank, Y, to serve as remarketing agent. Y will attempt to remarket the Notes with a Reset Rate that will permit the Notes to be sold for an amount equal to at least 100 percent of, and up to a target of 100½ percent of, a specific price ("Minimum Required Price"). There is no upper limit on the Reset Rate. For a remarketing on the Final Remarketing Date, the Minimum Required Price is the aggregate stated principal amount of the remarketed Notes. For remarketings before the Final Remarketing Date, the Minimum Required Price is the amount that could be invested in then-available zero-coupon Treasury securities ("Treasury Zeros") that mature

shortly before the Settlement Date and pay an amount equal to the sum of the aggregate stated principal amount of the remarketed Notes, plus the aggregate interest at the Initial Rate that would have been payable on the Notes on the Settlement Date if the Notes had not been remarketed.

The remarketings will include all of the Notes contained in Purchase-Contract/Note units on the remarketing dates. In addition, holders of Separated Notes may elect to include those Notes in the remarketings. If a remarketing succeeds, the interest rate on all the Notes will be changed from the Initial Rate to the Reset Rate for the remaining term of the Notes, whether or not they were included in the remarketing.

A remarketing will not occur if a condition precedent to the remarketing (for example, the existence of an effective registration statement for the Notes) is not fulfilled. Moreover, even if all conditions are satisfied and a remarketing does occur, the remarketing will not succeed if Y is unable to obtain the Minimum Required Price. (In either case, the remarketing is said to "fail.") On the Issue Date, it is substantially certain that a remarketing of the Notes will succeed.

In the case of a Separated Note, if all of the remarketings fail, then, on the Settlement Date, the holder of the Note will have the right to put the Note to X in exchange for cash equal to the Note's stated principal amount plus any accrued but unpaid interest. If such a Note is not put to X, the Initial Rate will remain in effect for that Note until the Maturity Date.

In the case of a Note contained in a Purchase-Contract/Note unit, if all of the remarketings fail, X will exercise its rights as a secured party to dispose of the Notes in accordance with applicable law and satisfy in full the holder's obligation to purchase X's common stock under the Purchase Contract. As a result, the holder will receive the interest payment due on the Settlement Date and the amount of X's common stock deliverable under the Purchase Contract.

If a remarketing succeeds, the remarketing proceeds (or the proceeds of the Treasury Zeros in the case of a successful remarketing before the Final Remarketing Date) must be used by X in the following manner. If a Note was part of a Purchase-Contract/Note unit on the date of the successful remarketing, X must apply an amount equal to the stated principal amount of the Note to satisfy the former holder's obligation to pay the Settlement Price under the associated Purchase Contract.

In addition, X must pay the former holder cash in an amount equal to the interest (at the Initial Rate) that would have been payable to the holder on the Settlement Date had the Notes not been remarketed. If the successful remarketing occurs before the Final Remarketing Date, this amount will be paid out of the proceeds of the Treasury Zeros. If the successful remarketing occurs on the Final Remarketing Date, the amount will be paid out of X's own funds. X will make similar payments to the former holders of any participating Separated Notes.

Y will receive a remarketing fee of one quarter of one percent of the Minimum Required Price. This remarketing fee will be paid first from the excess, if any, of the remarketing proceeds over the Minimum Required Price and then, if necessary, by X from its own funds. If any proceeds in excess of the Minimum Required Price are not applied to the remarketing fee (that is, if the proceeds are between 100¼ percent and 100½ percent of the Minimum Required Price), these excess proceeds will be distributed to the former holders of the remarketed Notes (including any participating Separated Notes).

Purchase-Contract/Note units are listed on a national securities exchange. Purchase-Contract/Strip units and Separated Notes are not so listed but are freely assignable without restrictions on their transferability.

The Purchase Contract provides that, in the event of X's bankruptcy, the Purchase Contract will terminate and the associated Note or Strip will be released to the holder. On the Issue Date, X reasonably believes, based on advice from counsel, that this provision will be enforceable in bankruptcy and will result in the holder of a Purchase-Contract/Note unit being treated as a creditor in any bankruptcy proceeding.

Based on the terms of the Note and other facts and circumstances, if the Note were issued independently of the Purchase Contract in a transaction that did not link the rights and obligations under the Note with the rights and obligations under the Purchase Contract, then the Note would qualify as debt for federal income tax purposes, interest accruing on the Note would be deductible unless § 163(l) applies, and, under § 1.1001-3 of the Income Tax Regulations, the Note in existence before a successful remarketing would continue to exist after the remarketing. That is, the Note would not be treated as having been retired in conjunction with the issuance of a new debt instrument that bears an interest rate equal to the Reset Rate.

LAW AND ANALYSIS

As stated above, the Note would qualify as debt for federal income tax purposes if it were issued independently of the Purchase Contract in a transaction that did not link the rights and obligations under the Note with the rights and obligations under the Purchase Contract. Upon the earlier of a conversion, a settlement with separate cash, or a successful remarketing of the Note, the Note will no longer be linked with the Purchase Contract. At that time, the Note will qualify as debt for federal income tax purposes. Interest accruing on the Note after that time will be deductible under § 163(a).

On the other hand, during the time that the Note is contained in a Purchase-Contract/Note unit, there is an issue of whether the bundle of rights and obligations resulting from the unit should be treated for federal income tax purposes as consisting of a debt instrument and a stock purchase contract. An important initial inquiry bearing on whether the Note may be separately analyzed for federal income tax purposes is whether the Note is separable from the Purchase-Contract/Note unit. Even if the Note is separable, however, various features of the Note and Purchase Contract raise the possibility that, for federal income tax purposes, the Purchase-Contract/Note unit nevertheless is treated as some

other combination of instruments. For example, a Purchase-Contract/Note unit could be treated as a prepaid forward contract to purchase a variable quantity of X's stock together with options (1) to acquire a Note by tendering a Strip to be combined into a Purchase-Contract/Strip unit or (2) to purchase a Note for cash by settling the forward contract early, together with a commitment by X to issue new Notes in the context of a "remarketing."

The correct characterization for federal income tax purposes of a transaction creating multiple rights and obligations depends on the facts and circumstances of the particular transaction. In deciding among multiple potential characterizations, the tax law seeks to find the best match between the bundle of rights and obligations and one or more categories of widely recognized instruments. In the instant case, the form chosen for the components of the unit reflects one reasonable division of the bundle of rights and obligations in the unit. Consequently, it is appropriate to begin the analysis of the issuer's tax consequences with respect to the unit by treating the unit as comprising these two components—namely, the Note and the Purchase Contract.

After the Note has been identified as one of the components of the Purchase-Contract/Note unit, determining whether X may deduct the amounts identified as interest on the Note contained in the Purchase-Contract/Note unit involves a multi-step analysis:

Is the Note separable from the associated Purchase Contract?

If the Note is separable from the Purchase Contract but is not in fact separated from the Purchase Contract, does the Note qualify as debt?

If the Note qualifies as debt, does § 163(l) prevent X from deducting the interest that accrues on the Note?

Is the Note separable from the associated Purchase Contract?

Two factors are particularly important in analyzing whether the Note should be treated as separable from the Purchase Contract: whether the Purchase Contract and Note are separately transferable, and whether any factors (economic or otherwise) prevent the holder from effecting such a separate transfer.

Separate Transferability

Rev. Rul. 88-31, 1988-1 C.B. 302, holds that a share of common stock and a contingent payment right issued together as an investment unit are separate items of property for federal income tax purposes because they are separately tradable on a national securities exchange shortly after issuance. Similarly, in cases involving bond-warrant investment units in which the bond and warrant were separately tradable, several courts have stated in dicta that, because of the potential for separate trading, the bond and warrant were properly treated as separate instruments. See *Chock Full O'Nuts Corp. v. United States*, 453 F.2d 300 (2d Cir. 1971); *Hunt Foods and Industries, Inc. v. Commissioner*, 57 T.C. 633 (1972). In contrast, when financial instruments cannot be separately traded, the

courts have generally treated them as a single instrument. See *Universal Castings Corp. v. Commissioner*, 37 T.C. 107 (1961) (finding that a corporation's notes were "locked" to its stock by a shareholders' agreement so that neither the note nor the stock could be sold without the other, and therefore holding that the notes and stock constituted a "single investment" and the notes did not qualify as debt), *aff'd*, 303 F.2d 620 (7th Cir. 1962). Cf. *De Coppet v. Commissioner*, 38 B.T.A. 1381 (1938) (finding that an investment corporation's stock was "stapled" to a bank's stock through a trust arrangement so that neither could be sold without the other, and therefore holding that no part of the basis of the taxpayer's stapled stock could be recognized as a loss when the stock of the investment corporation became worthless), *aff'd*, 108 F.2d 787 (2d Cir.), *cert. denied*, 310 U.S. 646 (1940). These authorities indicate that, unless a holder has a legal right to separate linked instruments, they generally cannot be considered separable.

Economic Compulsion

The existence of a mere legal right to separate is insufficient for the Note and Purchase Contract to be considered separable. If the characterization of an instrument or a transaction for federal income tax purposes either depends on, or could be affected by, the existence of a person's legal right or option to elect a certain course of action, the tax consequences often depend on whether the exercise (or nonexercise) of the right or option is economically compelled based on all the facts and circumstances. See *American Realty Trust v. United States*, 498 F.2d 1194, 1199 (4th Cir. 1974) (upholding a verdict that a transaction was a good-faith sale and lease-back with a repurchase option, in part because the seller was not under "economic compulsion" to exercise the option); *Roberts v. Commissioner*, 71 T.C. 311, 323 (1978) (holding that a trust was not a mere conduit used by the taxpayer to obtain installment sale treatment under § 453 for a stock sale, in part because the trustees were under "no legal commitment or economic compulsion" to resell the stock when they did), *aff'd*, 643 F.2d 654 (9th Cir. 1981); Rev. Rul. 2003-7, 2003-5 I.R.B. 363 (holding that a collateralized forward contract to sell stock is not a current sale if the shareholder is not economically compelled to deliver the pledged shares); see also *Comtel Corp. v. Commissioner*, 45 T.C. 294, 307 (1965) (arrangement for stock purchase and subsequent sale of stock pursuant to an "option" was characterized as in substance a financing arrangement, in part because the Court concluded, after evaluation of the economic terms of the transaction, that taxpayer was "practically compelled" to exercise the option), *aff'd*, 376 F.2d 791, 796 (2d Cir.) (rejecting taxpayer's argument that it was not "economically compelled" to exercise the option), *cert. denied*, 389 U.S. 929 (1967); cf. Rev. Rul. 82-150, 1982-2 C.B. 110 (treating the holder of an option to purchase stock as the current owner because the holder paid 70 percent of the stock's value for the option and the strike price of the option was 30 percent of the stock's value).

For a Note to become separated from the Purchase-Contract/Note unit and transferable separately, one of three events must occur: (1) the holder effects a conversion, (2) the holder effects a settlement with separate cash, or (3) a successful remarketing occurs. If all of the remarketings fail, a Note in a Purchase-Contract/Note unit in effect will be exchanged on the Settlement Date for the X stock that is due to the holder under the Purchase Contract.

Notwithstanding these conditions and possibilities, however, under the facts stated in this ruling, the holder has the unrestricted legal right to separate the Note from the Purchase-Contract/Note unit and transfer the Note separately, and is not economically compelled to keep the unit unseparated. The need to take certain steps to effect a separation does not contradict the separateness that can ultimately be achieved. On the Issue Date, it is substantially certain that the remarketing will succeed; thus, the consequences of a hypothetical remarketing failure are not controlling. Accordingly, in light of all the facts and circumstances, when the Notes and Purchase Contracts were issued they were separable instruments.

If the Note is separable from the Purchase Contract but is not in fact separated from the Purchase Contract, does the Note qualify as debt?

Whether an instrument is debt for federal income tax purposes depends on the facts and circumstances of each case. No particular fact is conclusive in making such a determination. *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946). Among the factors considered by the courts are (1) whether there is an unconditional promise to pay a sum certain in money on a specific date, (2) the intent of the parties, and (3) the holder's right to enforce the payment of principal and interest. *Bauer v. Commissioner*, 748 F.2d 1365, 1368 (9th Cir. 1984); *Estate of Nixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972); *Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957); *Litton Business Systems, Inc. v. Commissioner*, 61 T.C. 367, 377 (1973) ("Was there a genuine intention to create a debt, with a reasonable expectation of repayment, and did that intention comport with the economic reality of creating a debtor-creditor relationship?"), *acq.*, 1974-2 C.B. 3.

In form, the transaction provides for investors to make an initial payment of money that will be repaid to the holder of a Note upon the maturity of the Note. Although the Note is pledged as collateral for satisfaction of the separate Purchase Contract, the payment obligation under that contract is intended to be satisfied out of the proceeds of the remarketing of the Note. However, an initial holder is obligated in all events to acquire X's stock and will not itself receive the principal payment on the Note unless the holder takes action to separate the Note from the Purchase Contract.

A question is thus presented whether the amount paid by an initial holder should be characterized as the purchase price for the Note or as a prepayment on the Purchase Contract, with the actual Notes being issued by X only if and when there is a conversion, a settlement for separate cash, or a successful remarketing. An important consideration in answering this question is whether the issuance and acquisition of the units create debt characteristics.

On the one hand, in addition to the conditions necessary to cause a separation of the Note from the Purchase-Contract/Note unit as described above, the following factors suggest that the amount paid by a holder to acquire a unit could be treated simply as a prepayment of the Settlement Price under the Purchase Contract:

1. Ownership of a Purchase-Contract/Note unit exposes the holder to no risk of loss from a decline in the value of the Note because (i) if the Note is sold through a successful remarketing, the holder of a Purchase-Contract/Note unit is assured of having on the Settlement Date the amount necessary to satisfy the holder's obligation under the Purchase Contract; and (ii) if all remarketings fail, the holder of a Purchase-Contract/Note unit nevertheless receives the stock the acquisition of which is provided for under the Purchase Contract.
2. Ownership of a Purchase-Contract/Note unit provides the holder virtually no opportunity for gain from an increase in the value of the Note because the Initial Rate will be reset and the gain to be received from a remarketing is limited to 25 basis points.
3. Absent bankruptcy or the holder's decision to effect a conversion or a settlement with separate cash, the holder of a Purchase-Contract/Note unit will receive X's stock in all events under the Purchase Contract and will not receive any payments on the Note other than accrued interest and a distribution of excess proceeds in the event of a successful remarketing.
4. Upon a successful remarketing of the Note prior to the Final Remarketing Date, the holder will receive on the Settlement Date an amount equal to interest at the Initial Rate rather than the amount earned on the Treasury Zeros purchased with the proceeds from the remarketing.

On the other hand, the form in which the transaction is cast is a debt instrument, with a term that is substantially certain to last 5 years, with current interest payments, and with a remarketing that is to occur no later than 3 years after the Issue Date and that is not considered to be a reissuance under § 1001.

In addition, the Note has a critical debt characteristic even before the Note is separated from the Purchase Contract because the Purchase Contract provides that, in the event of X's bankruptcy, the Purchase Contract will terminate and the associated Note will be released to the holder; and on the Issue Date, X reasonably believes, based on the advice of counsel, that the provision will be enforceable in bankruptcy and will result in the holders being treated as creditors in the bankruptcy proceeding. The existence of these bankruptcy rights is an important debt characteristic. See *P.M. Finance Corp. v. Commissioner*, 302 F.2d 786, 789–90 (3d Cir. 1962) (describing the right to share with general creditors in a corporation's assets in the event of dissolution or liquidation as "a most significant characteristic of the creditor-debtor relationship"); *Nestlé Holdings, Inc. v. Commissioner*, 94 T.C. 803, 813–14 (1990) (distinguishing mandatorily redeemable preferred stock from debt in part because preferred stockholders are always subordinate to creditors in liquidation).

In this context, the foregoing debt characteristics are sufficient to cause a Note included in a Purchase Contract/Note unit to be treated as debt for federal income tax purposes. If the Note qualifies as debt, does § 163(l) prevent X from deducting the interest that accrues on the Note? Section 163(l)(1) disallows a deduction for any interest paid or

accrued on a "disqualified debt instrument." Section 163(l)(2) defines a "disqualified debt instrument" as indebtedness of a corporation that is payable in equity of the issuer or a related party. Section 163(l)(3) provides that indebtedness shall be treated as "payable in equity" of the issuer or a related party only if (A) a substantial amount of the principal or interest is required to be paid in or converted into, or at the option of the issuer or a related party is payable in or convertible into, such equity; (B) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of such equity; or (C) the indebtedness is part of an arrangement that is reasonably expected to result in a transaction described in (A) or (B). Section 163(l)(3) further provides that principal or interest shall be treated as required to be so paid, converted, or determined if it may be required at the option of the holder or a related party and there is a substantial certainty the option will be exercised.

The legislative history of § 163(l) states that an instrument is treated as payable in stock if it is part of an arrangement designed to result in payment with or by reference to such stock, including certain issuances of a forward contract in connection with the issuance of debt, nonrecourse debt that is secured principally by such stock, or certain debt instruments that are convertible at the holder's option when it is substantially certain that the right will be exercised. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 523–24 (1997), 1997–4 (Vol. 2) C.B. 1993–94.

All of the interest payments on all of the Notes will be made in cash. The principal payments on Separated Notes as well as Notes that have been sold in a remarketing will also be made in cash. Thus, if there is a successful remarketing, the principal payments on all of the Notes will be made in cash at the end of the 5–year term. If all of the remarketings fail, however, X's obligation to pay the stated principal amount of the Notes contained in the Purchase-Contract/Note units will be offset against the obligation of the holders to pay the Settlement Price on the Purchase Contracts. In that case, although the Note contained in a Purchase-Contract/Note unit technically will be applied in satisfaction of the holder's obligation to pay the Settlement Price rather than paid in stock, the holder will effectively receive X's stock in satisfaction of the stated principal amount of the Note. Thus, the Note may be considered to be "paid in" or "converted into" X's stock for purposes of § 163(l)(3).

Even without either a provision in the written terms of the Notes or any other understanding or agreement, in certain situations the facts and circumstances might support a conclusion that the issuance was part of an arrangement reasonably expected, in effect, to give X an option either to repay the Note with X's stock or to convert the Note into X's stock, or otherwise to result in such a repayment or conversion. For example, if X does not use its best efforts to make the remarketing succeed and all of the remarketings fail, the holder in effect will be compelled to receive X's stock in satisfaction of the stated principal amount of the Note.

In the instant transaction, however, several critical facts and contractual provisions support a contrary conclusion:

1. X has contracted to have the Notes remarketed and such an undertaking is subject to the requirements and sanctions of the Securities Act of 1933, 15 U.S.C. 77a–77aa (2000);
2. It is substantially certain that a remarketing of the Notes will succeed (in which case the Notes will remain outstanding until the Maturity Date and consequently will not be paid in, or converted into, X's stock);
3. The remarketing dates and the Maturity Date are such that the Notes will remain outstanding after the remarketing for a period that is significant both absolutely and relative to the total term of the Notes; and
4. On the Maturity Date, X will have an obligation to pay the principal amount of the Notes.

Thus, absent specific evidence of bad faith with respect to X's performance of its obligation to remarket the Notes, these critical facts and contractual provisions support the conclusion that the transaction is not reasonably expected to give X an option to pay the Notes in, or convert them into, X's stock, or to otherwise result in such a repayment or conversion .

Conclusion

The interest accruing on a Note contained in a Purchase-Contract/Note unit is deductible under § 163(a), and the deduction is not disallowed under § 163(l). Four factors critical to this conclusion are:

Critical Factor I. The holder has the unrestricted legal right to convert the Purchase-Contract/Note unit into a Purchase-Contract/Strip unit or to settle the Purchase Contract with separate cash and retain the Note, and the holder is not economically compelled to keep the unit unseparated.

Critical Factor II. The Purchase Contract provides that, in the event of X's bankruptcy, the Purchase Contract will terminate and the associated Note or Strip will be released to the holder; and, on the Issue Date, X reasonably believes, based on advice from counsel, that the provision would be enforceable in bankruptcy and would result in the holder of a Purchase-Contract/Note unit being treated as a creditor in the bankruptcy proceeding.

Critical Factor III. The period the Notes will remain outstanding after a remarketing is significant, both absolutely and relative to the total term of the Notes. For purposes of this factor, Notes are considered to remain outstanding only during the period when they are not subject to redemption at the option of the issuer.

Critical Factor IV. On the Issue Date, it is substantially certain that a remarketing of the Notes will succeed. For purposes of this factor, a remarketing of the Notes is not substantially certain to succeed if the Reset Rate is capped.

HOLDING

Under the facts presented, the interest accruing on a Note contained in a Purchase-Contract/Note unit is deductible under § 163(a), and the deduction is not disallowed under § 163(l).

PROSPECTIVE APPLICATION

Under the authority of § 7805(b)(8), the holding of this revenue ruling will not be applied adversely with respect to a unit that was issued on or before August 22, 2003, provided that interest accruing on the unit would be deductible under this revenue ruling if—

(1) Critical Factor II required only that, under the transaction documents, in the event of the issuer's bankruptcy, the Purchase Contract will terminate and the associated Note or Treasury security will be released to the holder; and

(2) Critical Factor IV required only that the issuer of the unit undertook a legal obligation to attempt to cause a remarketing to succeed and reasonably believed that a remarketing would succeed.

REQUEST FOR COMMENTS

The Internal Revenue Service and the Treasury Department are considering whether to issue regulations under § 163(l) to address the policy issues raised by the transaction described in this ruling. The Internal Revenue Service and the Treasury Department request comments as to whether regulations should be promulgated and, if so, what these regulations should provide.

Comments should be submitted by October 22, 2003. Comments may be submitted to CC:PA:RU (Rev. Rul. 2003–97), room 5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8:00 a.m. and 4 p.m. Monday to Friday to CC:PA:RU (Rev. Rul. 2003–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, comments may be submitted via the Internet at Notice.Comments@irs.counsel.treas.gov. All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this revenue ruling is Charles Culmer of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Mr. Culmer at (202) 622–3960 (not a toll-free call).