Lesson 2

Reissuances

Overview

Introduction

This lesson will discuss the reissuance rules. The reissuance rules govern situations in which there have been changes made to the terms of a bond after issuance. Some changes to the terms are so substantial that the bond ceases to be the same issue and is considered to be reissued. In effect, the original issue is considered to be retired, and a new bond issue takes its place. This lesson explains how to analyze changes in bond terms to determine if there has been a reissuance. It also discusses the consequences of a reissuance.

This lesson also discusses certain related topics such as consequences of the extinguishment of bonds and certain temporary relief provided to issuers which acquire and hold their own bonds.

Purpose

To identify and understand changes to bond terms that result in bond reissuances pursuant to § 1001 and the Regulations thereunder.

Objectives

After completing this lesson you will be able to:

- Describe the rules on reissuances
- Determine which rules apply to various types of bonds
- Identify a significant modification to bond terms
- Describe the consequences of a significant modification to bond terms
- Distinguish a qualified tender bond
- Determine the changes to a qualified tender bond that will result in a reissuance

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Overview, Continued

Contents

This lesson contains the following topics:

Introduction to Reissuances

Background

In *Cottage Savings Association v. Commissioner*, 111 S. Ct. 1503 (1991), the Supreme Court considered the question: "When is an exchange of property a taxable exchange of property under § 1001?"

Cottage Savings, a financial institution, simultaneously sold participation interests in mortgages to other financial institutions, and purchased from them participation interests in other mortgages. Cottage Savings argued that the exchange constituted a taxable exchange because the participation interests exchanged were "materially different" because the loans were secured by different properties and different mortgagors.

The IRS argued that no exchange had occurred because the properties were equal in value. The Court considered the issue based on the concept of "material difference" provided by Regulation § 1.1001-1(a). The Court found that the exchange was a taxable event because the interests were materially different due to the different legal entitlements involved.

This decision created some controversy because it led many to believe that even a slight change in bond terms would give rise to a reissuance. In response, proposed regulations under § 1001 were issued in 1992 to provide some guidance regarding when modifications to bond terms would constitute a reissuance. These were greeted with many comments and suggestions by taxpayers. Final regulations were issued in September 1996, which superseded I.R.S. Notice 88-130, 1988-2 C.B. 543 except with respect to qualified tender bonds rules. A series of bond reissuance notices were issued between 1988 and 2010. Temporary regulations were issued June, 2010 and final regulations were published January 7, 2011.

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How a Reissuance Works

City M has $20,000,000 principal amount outstanding from a 1984 bond issue yielding 9 percent. In 1998 City M is unable to make any debt service payments in the foreseeable future. City M has the following options:

- Default on the bonds, thereby ruining its credit rating and preventing it from obtaining future funds at a reasonable interest rate.
- Borrow from a bank — which given its current credit would be at a high rate of interest, if available.
- Sell assets or investments.
- Re-negotiate the terms of the bonds with the bondholders.

Let's assume that the bondholders agree to lower the interest rate from 9 percent to 6 percent, and to extend the maturity date by 5 years. The city has its bond rating intact, and the bondholders still have a viable investment. However, these changes have altered the bond terms so much that the original issue as altered is deemed to be "reissued" as a new issue.

Reissuance Rules

Although most rules related to tax-exempt bonds are in §§ 141 through 150, the reissuance rules are in Regulations § 1.1001. Regulations § 1.1001 governs the computation and recognition of gain or loss in the sale or disposition of property, including tax-exempt bonds. Regulations § 1.1001-1(a) clarifies that the term "disposition" includes an "exchange of property for other property differing materially either in kind or in extent." This provision brings certain modifications of the terms of bonds under §1001.

Regulations § 1.1001-3 applies to alterations of the terms of debt instruments on or after September 24, 1996. Taxpayers may also rely on this section for alterations of the terms of a debt instrument after December 2, 1992 and before September 24, 1996. This section provides rules for determining when a modification of the terms of a debt instrument results in an exchange for Regulations § 1.1001-1(a) purposes.

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Why should Issuers Care about the Effects?

Let's assume that City M invested its reserve fund from the 1984 bonds in long-term investments yielding 9.0125 percent. City M will care about the effects of a reissuance in 1990 for the following reasons:

First, unless the 1998 bonds can be considered to be a current refunding of the 1984 bonds, the 1998 bonds are now subject to the current tax laws, including rebate. Since the yield on the 1998 reissued bonds is lower than the yield on the original 1984 bonds, City M must rebate to the U.S. government any earnings on the investments in the reserve fund over the yield on the 1998 bonds.

Second, the bondholders will have to amend their tax returns to reflect the taxable exchange.

Results of a Reissuance

The consequences:

- On the effective date of the agreement, new bonds have been issued.
- The original bonds are considered to be retired.
- The new issue ***may*** be treated as a "current refunding" of the original bond issue.
- The bondholders would be required to report a taxable exchange under § 1001.
- The tax-exempt requirements that are in effect at the time of reissuance apply to the reissued bonds (i.e., change in yield, TEFRA approval, deemed terminations of integrated swaps, accelerating rebate payments ,volume cap, filing a new form Series 8038 information return and any new requirements that apply since the original bond issue).

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So There's a Reissuance, Now What?

Assume that you find that there has been a significant modification to the terms of a bond issue resulting in a reissuance. The next step is to determine if the new issue can qualify as a current refunding. There are a number or reasons why this would be a favorable result to the issuer. For example, a current refunding does not require volume cap and TEFRA approval.

Even if a bond issue does not meet the definition of a current refunding, the reissued bond must still qualify as a tax-exempt obligation. Additionally, the new bond issue must meet the tax laws in effect at the time of the reissuance. Conversely, if a bond issue meets the definition of a current refunding, it must meet the tax laws in effect at the time of the original bond issuance.

In the case of a reissuance, the bond yield must also be recalculated on the bond issue. If the bond yield changes, the restricted yield will change. Additionally, if the bond is reissued, the prior bond has been "redeemed" and a final rebate computation under § 148(f)(3) is required. A failure to comply with the requirements under § 148 will result in the "redeemed" prior bonds becoming taxable.

Part 1: Regulations § 1.1001-3

Overview

Introduction

Regulations § 1.1001-3(a)(1) provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of Regulations § 1.1001-1(a).

Regulations § 1.1001-3(b) provides the general rule for exchanges. It states that only a significant modification will result in an exchange.

Paragraphs (c) and (d) of that section respectively define “modification” and provide examples.

Paragraphs (e) and (f) respectively provide rules for determining when a modification is a significant modification and the rules of application.

General Scope

Regulations § 1.1001-3(a)(1) provides that this section applies to any modification of a debt instrument, regardless of the form of the modification such as:

- An exchange of a new instrument for an existing debt instrument.
- An amendment of an existing debt instrument.
- Modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties.

Regulations § 1.1001-3(a)(1) does not apply to exchanges of debt instruments between holders.

Regulations § 1.1001-3(a)(2) does not apply to determine whether tax-exempt bonds that are qualified tender bonds are reissued.

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Contents

This part contains the following topics:

Section 1:

Modifications to Debt Instruments

General Rules for Definition of Modification

Alteration of Terms

Regulations. § 1.1001-3(c)(1)(i) states that in general, a modification is any alteration of a legal right or obligation of the issuer or holder of a debt instrument whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties or otherwise.

Alterations which Occur by Operation of the Terms of the Instrument that are not Modifications

Regulations § 1.1001-3(c)(1)(ii) provides that except as provided in Regulations § 1.1001-3(c)(2), an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

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Exceptions

Regulations § 1.1001-3(c)(2) provides that the following alterations are modifications even if they occur by operation of the terms of a debt instrument:

(i) An alteration that results from the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or part) in the recourse nature of the instrument.

(ii) An alteration that results in an instrument or property right that is not debt for federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convey the instrument into equity of the issuer (notwithstanding paragraph (c)(2)(ii)).

(iii) An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless:

(A) the option is unilateral (as defined in paragraph (c)(3); and

(B) in the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.

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Definition of Unilateral Option

Under Regulations § 1.1001-3(c)(3), an option is unilateral if, under the terms of the indenture or applicable law:

- The other party does **not** have the right (at the time the option is exercised or as a result of the exercise) to alter or terminate the instrument, or put the instrument to a person related to the issuer;
- Exercise of the option does not require consent or approval of:
  - the other party,
  - a person related to the other party, or
  - a court or arbitrator; AND
- Exercise of the option does not require consideration (other than incidental costs) unless on the issue date of the instrument, the consideration is:
  - a de minimis amount,
  - a specified amount, or
  - an amount based on a formula using objective financial information

Options Flowchart

After you have determined whether or not the option is unilateral, use the flowchart in Figure A-1 to determine whether or not the alteration resulting from the exercise of the option is a modification.

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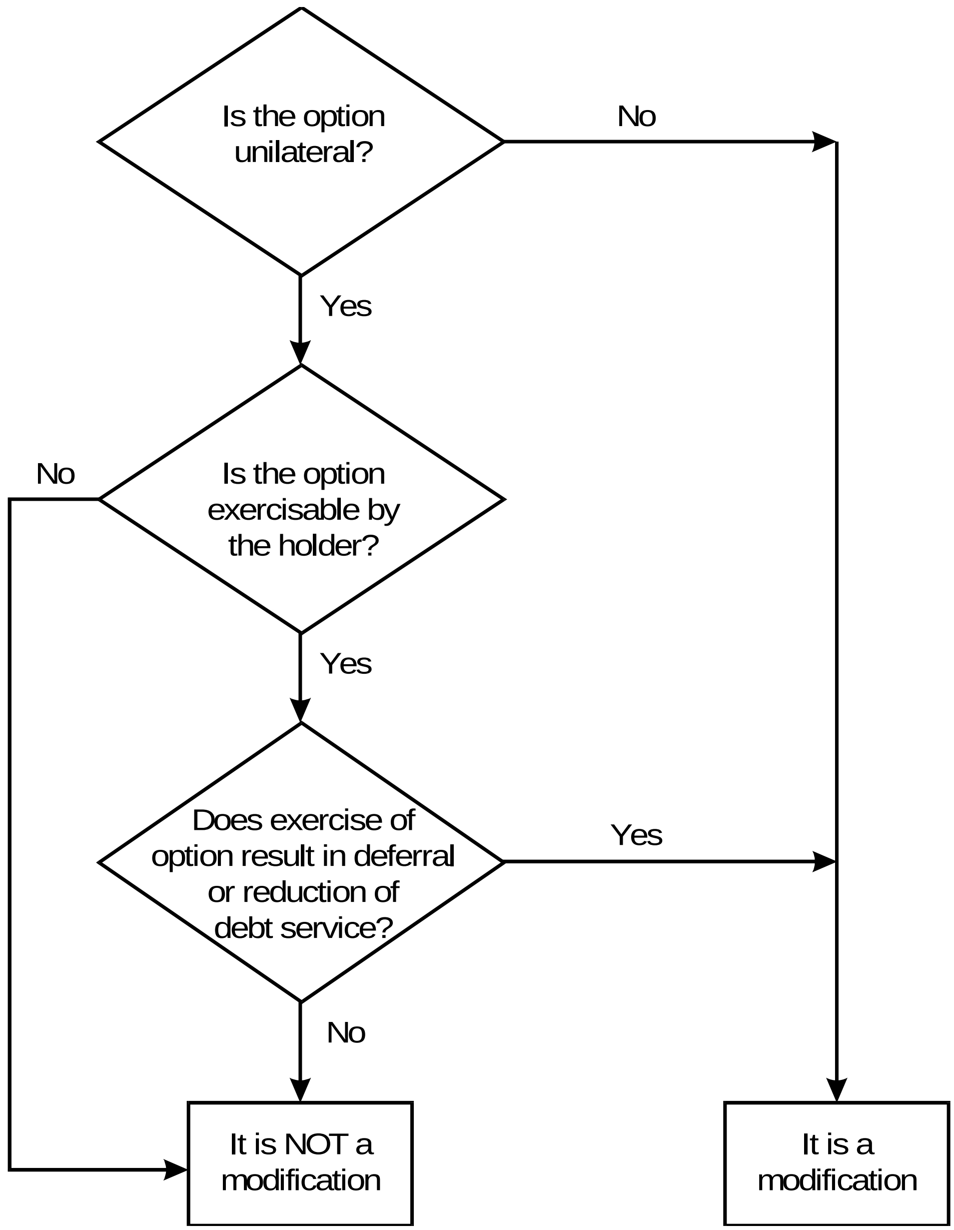
General Rules for Definition of Modification

Figure A-1

How to Tell if an Alteration Resulting from the Exercise of an Option in an Indenture Is a Modification



Failure to Perform

Notwithstanding Regulations § 1.1001-3(c)(1), under Regulations § 1.1001-3(c)(4) the failure of an issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification.

Absent a written or oral agreement to alter other terms of the debt instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds:

- Two years following the issuer's initial failure to perform; AND
- Any additional period during which the parties conduct good faith negotiations or during which the issuer is in a title 11 or similar case.

Example 1

A financial institution holds bonds issued by a municipality. The indenture provides for an increase in the interest rate paid on the bonds, if the marginal federal corporate income tax rate increases. When the corporate rate does increase, the financial institution waives its right to an increased interest rate. This waiver constitutes an alteration in the holder's legal rights, and it is a modification. The provision allowing for an adjustment in the interest rate does not constitute a modification because it occurs by operation of the bond terms. It is the holder's waiver of its right that constituted a modification.

See Rev. Rul. 87-19, 1987-1 CB 249.

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Example 2

City C is unable to make a scheduled payment of principal and interest on its outstanding bonds, thus defaulting on the bonds. Under the terms of the bonds, when the issuer fails to make a scheduled payment, the full principal amount of the bond is due immediately. The bondholders waive this right and instead negotiate new terms with the city.

According to Regulations § 1.1001-3(c)(4)(i), the issuer's failure to make the scheduled payment is not a modification. In addition, according to Regulations § 1.1001-3(c)(4)(ii), the bondholder's waiver of collection rights is not considered a modification, until the bondholders have waited for payment longer than two years. This time period can be extended as long as the parties are conducting good faith negotiations or the issuer is in receivership, foreclosure, or a similar proceedings as described in § 368(a)(3)(A). However, as soon as the parties reach agreement regarding new terms, these new terms may constitute a modification.

See Regulations § 1.1001-3(d) Example 13.

Example 3

The original terms of a bond provide that the interest rate is 9 percent. The terms also provide that, if the issuer files an effective registration statement covering the bonds with the Securities and Exchange Commission, the interest rate will decrease to 8 percent. If the issuer registers the bond, the resulting decrease in the interest rate occurs by operation of the terms of the bond and is not an alteration described in Regulations § 1.1001-3(c)(2), thus such a decrease in the interest rate is not a modification.

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Example 4

A county issues a 10-year note to a bank in exchange for cash. Interest on the note is payable semi-annually. Under the terms of the note, the bank may grant the county the right to defer all or part of the interest payments. For any payments that are deferred, interest will compound at a rate 150 basis points greater than the stated rate of interest. The county encounters financial difficulty and is unable to satisfy its obligations under the note. The bank exercises its option under the note and grants the county the right to defer payments. The exercise of the option results in a right of the county to defer scheduled payments and, under § 1.1001-3(c)(i), is not a unilateral option. Thus, the option is described in § 1.1001-3(c)(ii), and it is a modification.

Example 5

A financial institution holds a mortgage on a town's administrative building. Under the original terms of the mortgage, the financial institution has an option to decrease the interest rate. The financial institution anticipates that, if market interest rates decline, it may exercise this option in lieu of the mortgagor refinancing with another lender. The financial institution exercises the option to reduce the interest rate. The exercise of the option results in a reduction in scheduled payments and is an alteration described in Regulations § 1.1001-3(c)(2)(iii). Thus, it is a modification.

The General Rule Revisited

Remember that the general rule of Regulations § 1.1001-3(b) states that a modification that is not a **significant** modification is not an exchange for purposes of Regulations § 1.1001-1(a).

This section has discussed the types of changes to the terms of a debt instrument that may be considered a "modification." Once it is determined that there has been a modification, an analysis must then be made to determine if it is a "significant" modification.

A reissuance is only triggered when there has been a significant modification to the terms of the debt instrument. This is covered in Section 2.

Section 2

Significant Modifications

Overview

General Rule

Regulations § 1.1001-3(e) provides five specific rules for determining whether a modification is "significant" as well as an overall general rule.

The general rule in Regulations § 1.1001-3(e)(1) applies to those modifications that are not specifically described in paragraphs (e)(2) through (6). The rule states that a modification is significant only if, based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are **economically significant**.

In making a determination under the general rule, all modifications to the debt instrument (other than modifications subject to paragraphs (e)(2) through (6) are considered collectively, so that a series of such modifications may be significant when considered together even if each modification, considered alone, would not be significant.

This is an important rule to remember. As we will see, if a change in terms is not described in paragraphs (e)(2) through (6), then we will use the general rule to test for significance.

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Specific Rules

Regulations § 1.1001-3(e)(2) through (6) describes rules for particular changes in terms of instruments and provides guidelines as to when such changes are deemed "significant."

The specific rules are:

- Change in yield
- Change in timing of payments
- Change in obligor or security
- Change in nature of a debt instrument
- Change in accounting or financial covenants

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Overview, Continued

Contents

This part contains the following topics

Change in Yield

Applicability

Regulations § 1.1001-3(e)(2) applies to:

- Debt instruments that provide for only fixed payments
- Debt instruments with alternative payment schedules subject to Regulation § 1.1272-1(c)
- Debt instruments that provide for fixed yield subject to Regulation. § 1.1272-1(d) (such as certain demand instruments)
- Variable rate debt instruments

Regulations § 1.1272 covers yield computation of certain debt instruments subject to original issue discount.

Note: This section applies to both taxable and tax-exempt bonds, so some rules may not be relevant.

General Rule

A change in yield is significant if the annual yield on the modified debt instrument varies from the original annual yield by more than the greater of:

- 1/4 of 1 percent (0.25 percent), OR
- 5 percent of the annual yield of the unmodified obligation

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Adjusted Issue Price

Regulations § 1.1001-3(e)(2)(iii) provides that the yield on a modified instrument is the annual yield of a debt instrument with:

- An issue price equal to the adjusted issue price of the unmodified obligation on the date of modification (increased by accrued but unpaid interest and decreased by accrued bond issuance premium not yet taken into account and increased or decreased, respectively, to reflect payments made to the issuer or to the holder as consideration for the modification); AND
- Payments equal to the payments on the modified debt obligation from the date of the modification.

Example 6

A debt instrument issued at par has an original maturity of ten years and provides for the payment of $100,000 at maturity with interest payments at the rate of 10 percent payable at the end of each year. At the end of the fifth year, and after the annual payment of interest, the issuer and holder agree to reduce the amount payable at maturity to $80,000. The annual interest rate remains at 10 percent but is payable on the reduced principal. In applying the change in yield rule of paragraph § 1.1001-3(e)(2), the yield of the instrument after the modification (measured from the date that the parties agree to the modification to its final maturity date) is computed using the adjusted issue price of $100,000. With four annual payments of $8,000, and payment of $88,000 at maturity, the yield on the instrument after the modification for purposes of determining if there has been a significant modification is 4.332 percent. Thus, the reduction in principal is a significant modification.

Prepayment Penalty

A commercially reasonable prepayment penalty for a pro rata prepayment (as defined in Regulations § 1.1275-2(f)) is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument. Regulations § 1.1001-3(e)(2)(iii)(B).

Change in Timing of Payments

General Rule

A change in the timing of payments, including any resulting change in the amount of payments, is a significant modification if it results in a material deferral of scheduled payments. The deferral can be an extension of the final maturity date or a deferral of payments due prior to maturity. The materiality depends on all of the facts and circumstances, including:

- Length of deferral;
- Original term of the bond;
- Amounts of the payments that are deferred; and
- The time period between the modification and the actual deferral of payments

See Regulations § 1.1001-3(e)(3)(i).

Safe Harbor

Regulations § 1.1001-3(e)(3)(ii) provides for a safe harbor period. The deferral of one or more scheduled payments within the safe harbor period is **not** a material deferral (and not a significant modification) if the deferred payments are unconditionally payable by the end of the safe harbor period.

The safe harbor begins on the original due date of the first scheduled payment that is deferred.

The safe harbor extends for a period equal to the lesser of 5 years or 50 percent of the original term of the debt instrument.

The term of an instrument is determined without regard to any option to extend the original maturity and deferrals of de minimis payments are ignored. If the safe harbor period is not used in full, the unused portion may be carried over to a subsequent deferral.

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Change in Timing of Payments, Continued

Example 7

A 20 year debt instrument issued at par provides for the payment of $100,000 at maturity with an annual interest payment at the rate of 10 percent. At the beginning of the eleventh year, the issuer and holder agree to defer all remaining interest payments until maturity with compounding. The yield on the modified instrument remains at 10 percent. The safe harbor period of Regulations § 1.1001-3(e)(3)(ii) begins at the end of the eleventh year, when the interest payment for that year is deferred, and ends at the end of the sixteenth year. However, the payments deferred during this period are not unconditionally payable by the end of that 5-year period. Thus, the deferral of the interest payments is not within the safe harbor period. This modification materially defers the payments due under the instrument and is a significant modification.

Change in Obligor or Security

Introduction

Whether or not a change in obligor on a bond is a significant modification depends on whether or not the debt is recourse or nonrecourse.

Who is an Obligor?

According to Regulations § 1.1001-3(f)(5), the term "obligor" means the issuer of the bonds. Further, Regulations § 1.1001-3(f)(6)(i) states that the obligor of a tax-exempt bond is the entity that actually issues the bonds and not a conduit borrower of the proceeds. Further, Regulations § 1.1001-3(f)(5)(iv) states that the terms "conduit loan" and "conduit borrower" have the same meanings as in Regulations § 1.150-1(b).

Note: Transactions between holders of tax-exempt bonds and a borrower of a conduit loan may be an indirect modification. For example, a payment by the holder of a tax-exempt bond to a conduit borrower to waive a call right may result in an indirect modification of the tax-exempt bond by changing the yield on that bond.

Reference to Section 1.150-1

Regulations § 1.150-1(d)(2)(ii)(A) and (B), defines "obligor" and provides guidance about issues with different obligors. It states that an obligor may be the conduit borrower in an issue allocable to a purpose investment.

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Recourse vs Nonrecourse Debt

Regulations § 1.1001-3(f)(6) defines recourse debt as:

- a tax-exempt bond that does NOT finance a conduit loan; OR
- a tax-exempt bond that finances a conduit loan, unless both the bond and conduit loan are nonrecourse debt

Regulations § 1.1001-3(f)(6) states that nonrecourse debt includes a tax-exempt bond secured only by a trust (or escrow) holding government securities or tax-exempt government bonds that are reasonably expected to pay debt service.

General Rule for Recourse Debt

Regulations § 1.1001-3(e)(4)(i)(A) provides that the substitution of a new obligor on a recourse debt instrument is a significant modification.

Exception for Certain Asset Acquisitions

The substitution of a new obligor is not a significant modification under Regulations § 1.1001-3(e)(4)(i)(C) if:

- The new obligor acquires substantially all of the assets of the original obligor;
- The transaction does not result in a change in payment expectations; AND
- The transaction does not result in a significant alteration

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Change in Obligor or Security, Continued

Exception for Tax Exempt Bonds

Regulations § 1.1001-3(e)(4)(i)(D) provides that the substitution of a new obligor on a tax-exempt bond is not a significant modification if:

- The new obligor is a related entity to the original obligor as defined in § 168(h)(4)(A); AND
- The collateral securing the obligation includes the original collateral

Related Entities

Section 168(h)(4)(A) states that each governmental unit, and each agency or instrumentality of a governmental unit, is related to each other as long as they all derive their powers, rights, and duties from the same sovereign authority. Similarly, section 1.150-1(e) defines a controlled group as a group of entities controlled directly or indirectly by the same entity or group of entities within the meaning of paragraph (e) of 1.150. However, section 1.150-1(e)(3) provides an exception to the controlled entity rule for an entity that possesses substantial taxing, eminent domain, and police powers. For example, a city possessing substantial amounts of each of these sovereign powers is not a controlled entity of the state. .

Nonrecourse Debt

Under Regulations § 1.1001-3(e)(4)(ii), the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

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Addition or Deletion of Co-Obligor

The addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results in a change in payment expectations. If the addition or deletion of a co-obligor is part of a transaction or series of related transactions that results in the substitution of a new obligor, however, the transaction is treated as a substitution of a new obligor (and thus is tested under § 1.1001-3(e)(4)(i), "Substitution of a new obligor on recourse debt instruments" rather than as an addition or deletion of a co-obligor.

Example 8

A recourse debt instrument with a 9 percent annual yield is secured by an office building. Under the terms of the instrument, a purchaser of the building may assume the debt and be substituted for the original obligor if the purchaser has a specified credit rating and if the interest rate on the instrument is increased by one-half percentage (50 basis points). The building is sold, the purchaser assumes the debt, and the interest rate increases by 50 basis points. If the purchaser's acquisition of the building does not satisfy the requirements of Regulations § 1.1001-3(e)(4)(i)(B) or (C), the substitution of the purchaser as the obligor is a significant modification. If the purchaser acquires substantially all of the assets of the original obligor, the assumption of the debt instrument will not result in a significant modification if there is not a change in payment expectations and the assumption does not result in a significant alteration. The change in interest rate, if tested under the rules of Regulations § 1.1001-3(e)(2) would result in a significant modification since it is greater than 0.45 percent (5 percent of 9 percent annual yield). The change in interest rate that results from the transaction is a significant alteration.

Coordination of Regulations §§ 1.1001-3 and 1.150-1

Short Review

We learned earlier in this section that a change in obligor on tax-exempt bonds would not be a deemed reissuance if the obligors were related and the collateral includes the original collateral. We also learned that under Regulations § 1.1001-3 that "obligor" means the issuer of the bonds, and not the conduit borrower. We also learned that whenever we have a deemed reissuance of a tax-exempt bond, it will usually be considered to be a current refunding if the obligor of the original issue is the same as (or a related party to) the obligor of the reissued bonds as required under Regulations § 1.150-1(d)(2)(ii). Let's turn to Regulations § 1.150-1(d)(2)(ii)(A), which discusses refunding issues with different obligors.

Note: See also Proposed Regulation (REG 165706-01, April 10, 2002), 67 Fed. Reg. 17309 (2002).

Why Do We Care?

Certain federal tax requirements which must be satisfied for a reissued bond issue do not apply to a refunding bond issue (e.g., volume cap allocation, public approval requirement).

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Coordination of Regulations §§ 1.1001-3 and 1.150-1, Continued

Obligor Under Regulation 1.150-1

Regulations § 1.150-1(d)(2)(ii)(A) states that to be a refunding issue the obligor of the refunding issue must be the same or related to the obligor of the refunded issue. The term "obligor" is defined in Regulations § 1.150-1(d)(2)(ii)(B) as the actual issuer of the issue, unless there is a conduit borrower, in which case the conduit borrower is the obligor of the issue. Now let's reconcile these definitions as they apply to tax-exempt recourse debt:

Relationship of the Obligors	Under Regulations §1.1001-3	Under Regulations §1.150-1
Related Issuers	Not a Reissuance	Refunding
Unrelated Issuers	Reissuance	Not a Refunding
Related Conduit Borrowers	Not an Obligor*	Refunding
Unrelated Conduit Borrowers	Not an Obligor*	Not a Refunding
***Note**: Under Regulations § 1.1001-3, a conduit borrower is not an obligor; however, this could still trigger a reissuance if the change also results in a change in security (and a change in payment expectations).		

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Data for Examples

Let's look at some examples to see how these definitions relate to each other.

Here is our cast of characters:

Issuer A	Conduit Borrower A
Issuer B	Conduit Borrower B
Issuer C	Conduit Borrower C

Issuers A and B are related to each other but to no one else.

Conduit Borrowers A and B are related to each other but to no one else.

All of the issuers are governmental units, and all of the borrowers are exempt entities described in § 501(c)(3).

All of the debt is recourse debt.

Example 9 Related Issuers

Issuer A issues bonds to update the municipal electrical system. Electrical service revenues and general credit are pledged to pay debt service. Later, Issuer A dissolves into Issuer B and Issuer B substitutes its name on the bonds as the obligor.

Q: What are the effects of this change under Regulations §§ 1.1001-3 and 1.150-1?

A: Under Regulations § 1.1001-3(f)(5)(i), the obligor is always the issuer. Under § 1.1001-3(e)(4)(i)(D), since the issuers are related, the change does not constitute a significant modification. Because there is no reissuance, there is no reason to look at the issue under Regulations § 1.150-1.

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Example 10 Unrelated Conduit Borrowers

Issuer A issues bonds and lends the proceeds to Borrower A. The bonds are secured by a note from Borrower A to Issuer A. Later, Borrower A sells the property built with the proceeds to Borrower C, who signs a new note to Issuer A for the outstanding amount.

Q: What are the effects of this transaction?

A: Under Regulations § 1.1001-3(f)(5)(i), the obligor is always the issuer, and the issuer has not changed. There can't be a reissuance due to a change in obligor under Regulations § 1.1001 because the conduit borrower is never considered to be an obligor. Because the note is the security for the bond, we must determine if there has been a reissuance due to a change in security. Regulations § 1.1001-3(e)(4)(iv) tells us that a change in security is a significant modification if the modification results in a change in payment expectations. The obligor's capacity to pay debt service includes the borrowers' ability to pay. If both borrowers have equal credit ratings, then there would be no change in payment expectations, and there would not be a reissuance. If there was a change in payment expectations, then there would be a reissuance.

If there is a reissuance under Regulations § 1.1001-3, then we would have to verify whether the reissued bond may be classified as a refunding bond under Regulations § 1.150-1. Under § 1.150-1(d)(2)(ii), the obligors are unrelated conduit borrowers. Section 1.150-1(d)(2)(ii)(A) requires that the obligors be related in order to constitute a refunding. Because they are not, this transaction would be classified as a new issue used to acquire assets.

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Example 11 Unrelated Issuers

Issuer A issues bonds to repair and maintain a sewer system. Sewer revenues and general credit are pledged to pay debt service. Later, Issuer A turns over operation of the system to Issuer C, and Issuer C substitutes itself as obligor on the bonds. Sewer revenues will still pay debt service.

Q: What are the effects of this transaction?

A: Under Regulations § 1.1001-3(e)(4)(i)(D), since the obligors are unrelated, the transaction results in a significant modification and a reissuance.

Under Regulations § 1.150-1(d)(2)(ii), since the obligors are unrelated, there cannot be a refunding. Therefore, it would be classified as an asset acquisition.

Example 12 Original Bonds are Retired

Issuer A issues bonds to build a new airport terminal. Airport revenues are expected to pay debt service. Later, Issuer A sells the terminal and its operations to Issuer C. Issuer A uses the sale proceeds to redeem the bonds. Issuer C immediately issues new bonds to finance the purchase, using the airport revenues as security.

Q: What are the effects of this transaction?

A: Regulations § 1.1001-3 does not apply to these bonds because the original bonds have been retired and new bonds have been issued. Under Regulations § 1.150-1(d)(2)(ii), this would be considered to be an asset acquisition because Issuer A and Issuer C are unrelated obligors.

Q: How would this change if Issuer B purchased the airport?

A: Again, Regulations § 1.1001-3 does not apply because the original bonds have been retired and new bonds have been issued.

Under Regulations § 1.150-1(d)(2)(ii), Issuer B's issue would be considered to be a refunding of the first issue because the proceeds of Issuer B's issue were used to retire Issuer A's issue.

Change in Security or Credit Enhancement

Recourse Debt

Regulations § 1.1001-3(e)(4)(iv)(A) states that a modification that releases, substitutes, adds, or otherwise alters the:

- Collateral for,
- A guarantee on, or
- Other form of credit enhancement for

A recourse debt instrument is a significant modification, **if** the modification results in a change in payment expectations.

Nonrecourse Debt

Regulations § 1.1001-3(e)(4)(iv)(B) states that, with certain exceptions, a modification that releases, substitutes, adds, or otherwise alters a substantial amount of the:

- Collateral for,
- A guarantee on, or
- Other form of credit enhancement for

A nonrecourse debt instrument is a significant modification.

Exceptions for Nonrecourse Debt

The following modifications of security of nonrecourse debt are **not** significant modifications:

- Substitution of collateral where the specific units pledged are easily exchangeable (for example, government securities or financial
- instruments of a particularly type and rating);
- Substitution of a similar commercially available credit enhancement contract; OR
- Improvement to the property securing the obligation

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Change in Security or Credit Enhancement, Continued

Change in Priority of a Debt

Regulations § 1.1001-3(e)(4)(v) states that a change in the priority of an obligation relative to the issuer's other debt is a significant modification if it results in a change in payment expectations.

Change in Payment Expectations

A change in payment expectations occurs if, as a result of the transaction:

- There is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modifications and is adequate after the modification; OR

- There is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

The obligor's capacity includes any source for payment, including collateral, guarantees, or other credit enhancement.

See Regulations § 1.1001-3(e)(4)(vi).

Change in the Nature of a Debt Instrument

General Rule

Regulations § 1.1001-3(e)(5)(i) provides that a modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification. For these purposes deterioration of the financial condition of the obligor between the issue date and the date of modification (relating to the obligor's ability to repay the debt) is not taken into account unless in connection with the modification there is a substitution of a new obligor or the addition or deletion of a co-obligor.

Change in Recourse Nature

In general, except as provided below, a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification. For example, a legal defeasance of a debt instrument in which the issuer is released from all liability to make payments on the debt instrument (including an obligation to contribute additional securities to a trust if necessary to provide sufficient funds to meet all scheduled payment on the instrument) is a significant modification. Similarly, a change in the nature of a debt instrument from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) is a significant modification.

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Exceptions

Regulations § 1.1001-3(e)(5)(ii)(B)(1) provides that a defeasance of a tax-exempt bond is not a significant modification, even if the issuer is released from any liability to make payments, IF:

- The defeasance occurs by operation of the terms of the original bond; AND

- The issuer places in escrow government securities or tax-exempt government bonds that are expected to pay the debt service.

Regulations § 1.1001-3(e)(5)(ii)(B)(2) provides that a modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a signification modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations. If the original collateral is fungible or otherwise of a type where the particular units pledged are unimportant (e.g. government securities) replacement of some or all units of the original collateral with other units of the same or similar type and aggregate value is not considered a change in the original collateral.

Change in Accounting or Financial Covenants

General Rule

A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.

How to Use the Rules to Test for Significance

General Rule

Regulations § 1.1001-3(f)(1) provides that a modification should be tested first under each specific rule listed in paragraphs (2) through (6) of § 1.1001-3(e).

If the modification is not specifically addressed in one of these paragraphs, then the general rule of Treas. Reg. § 1.1001-3(e)(1) should be used employing a facts and circumstances test to determine whether the legal rights or obligations are altered such that the modification is "economically significant."

Contingent Modifications

If the modification is described in Regulations § 1.1001-3(e)(2) through (6) but is effective only upon the occurrence of a substantial contingency, then the determination of whether or not the modification is significant should be made using the general rule under § 1.1001-3(e)(1). See Regulations § 1.1001-3(f)(1)(ii).

Modifications That Do Not Meet the Significance Tests

If a modification is of the same type under Regulations § 1.001-3(e)(2) through (4), but does not meet the applicable threshold required to be a significant modification as set forth in the regulations, then it is **not** a significant modification under that rule. See Regulations § 1.1001-3(f)(2).

If a change in terms results in a change in yield of less than the greater of 0.25 percent or 5 percent of the annual yield of the unmodified instrument, there is not a significant modification under this rule. However, that does not eliminate the possibility that there could be a significant modification under another rule, or even the general rule.

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Cumulative Effects of Modification

Regulations § 1.1001-3(f)(3) states that two or more modifications over any period of time constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification under any of the rules of § 1.1001-3(e).

When testing for changes in yield though, any prior modification which occurred more than 5 years before the modification being tested is disregarded.

Modifications of Different Terms

Regulations § 1.1001-3(f)(4) states that modifications of different terms, none of which are separately significant under paragraphs (e)(2) through (e)(6), are not collectively significant modifications.

For example a change in yield that is not a significant modification under (e)(2) and a substitution of collateral that is not a significant modification under (e)(4)(iv) do not together result in a significant modification. Although the significance of each modification is determined independently, in testing a particular modification it is assumed that all other simultaneous modifications have already occurred.

Note, however, that in applying the general rule under Regulations § 1.1001-3(e)(1), all modifications (other than modifications subject to paragraphs (e)(2) through (e)(6)) are considered collectively so that a series of such modifications may be significant when considered together although each modification, considered alone, would not be considered significant.

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Example 13

Under the terms of a 30-year fixed rate bond, the issuer can call the bond for 102 percent of par at the end of 10 years. At the end of the 8^{th} year, the holder of the bond pays the issuer to waive the issuer's right to call the bond at the end of the 10^{th} year. On the date of the modification, the issuer's credit rating is approximately the same as when the bond was issued, but market interest rates have declined from that date.

The holder's payment changes the yield on the bond. That change must be evaluated to determine if it is enough to result in a significant modification. If the change in yield is not a significant modification, the elimination of the issuer's call right must also be tested for significance. Because Regulations § 1.1001-3(e) does not specifically address this change, its significance must be evaluated under the general rule of Regulations §1.1001-3(e)(1). Regulations § 1.1001-3(g) Example 1.

Determining Whether the New Issue is a Current Refunding

Remember that even though the new issue has been determined to be a reissuance, you're not done yet. Determinations regarding whether or not the new issue qualifies as a current refunding under Regulations § 1.150-1(d)(2) and, if applicable, the Transitional Rules of section 1313(a) are still required.

Part 2

Qualified Tender Bonds

Overview

Introduction

In Part 1, we learned that the reissuance rules of Regulations § 1.1001-3 cover all bonds except tax-exempt bonds that are qualified tender bonds. See Regulations § 1.1001-3(a)(2). We also learned that qualified tender bonds are required to meet the applicable rules of Notice 88-130 which, in some instances, incorporate the requirements under § 1.1001-3. Part 2 will discuss these rules for qualified tender bonds.

Qualified tender bonds deserve their own set of rules because they are different from other bonds and cannot easily be analyzed under Regulations § 1.1001-3. These rules are summarized in Notice 88-130, which is generally effective for bonds originally sold after December 14, 1988. However, the rules apply retroactively to any bond that is subject to a tender right regardless of when sold, with some exceptions for bonds sold on or before December 14, 1988.

Contents

This part contains the following topics:

Variable Rate Demand Obligations

General

Variable rate bonds, or "variable rate demand obligations," differ from fixed rate bonds in two important ways:

- The interest rate on variable rate bonds changes periodically on a certain date determined in the indenture
- Bondholders can demand that their bonds be purchased by the tender agent at specified intervals

These features are discussed in more detail below.

Interest Rate Changes

The rate usually changes on a daily, weekly, or monthly basis, but can also change quarterly, semi-annually, or annually. The rate is usually based on an index plus a spread.

For example, let's assume that the indenture provides that the interest rate will be reset on the last day of each month based on 65% of LIBOR. At the end of each month, the rate will be re-established according to the index, and will apply for the coming month.

Continued on next page

Variable Rate Demand Obligations, Continued

Demand Feature

Generally, prior to the final maturity date, each time the interest rate changes, the holder can tender the bonds for purchase at par plus accrued interest. This is called a tender right. Sometimes the demand feature may be allowed more often than the interest rate change.

The bond indenture will specify when the bondholders can tender their bonds. This means that bondholders who want to sell their bonds contact the tender agent, notifying the agent that the bonds will be tendered for sale. The tender agent contacts a dealer, who attempts to sell the bonds to another investor.

Because bondholders have this right to tender their bonds, the issuer usually has some means available to provide cash to purchase the bonds if other investors aren't available. Some common methods of providing cash are letters of credit or standby purchase agreements.

As you can guess, although these bonds are considered to be long-term obligations, they carry short-term yields.

Qualified Tender Bonds

Overview

Notice 88-130, 1988-52 C.B. 543, 1988 defines a qualified tender bond and sets forth the basic rules governing qualified tender bonds. The Notice applies to any bond originally sold after December 14, 1998.

The rules apply to any bond subject to a tender right regardless of when sold, However, there is an exception for a bond originally sold on or before December 14, 1988:

- (1) no bond that is subject to a tender right will be treated as retired on a tender date solely by reason of the existence of the exercise of a tender right;
- (2) the rule set forth in Section A2.2 of the Notice regarding when a qualified tender bond will be treated as retired will not apply; and
- (3) a change which would have caused a retirement under Section A.2.2 of the Notice will result in a retirement of the bond only if it would result in a disposition of the bond for purposes of § 1001.

Definition

A qualified tender bond is any tender bond which has a final stated maturity date no later than the earlier of:

a) The date which is 35 years after the date of issue; OR

b) The latest date reasonably expected (as of the date of issue) to carry out the governmental purpose of the issue of which the bond is a part.

A bond will be deemed to meet (b) above if the average maturity of the issue of which the bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with the proceeds of such issue (as determined under § 147(b)).

Continued on next page

When Are Qualified Tender Bonds Considered To Be Retired?

According to Notice 88-130, a qualified tender bond will be considered to be retired and reissued for purposes of § 103 and §§ 141-150 only if in a transaction or series of transactions:

- There is any change to the terms of the bond (other than a qualified corrective change) in connection with a qualified tender change which changes the time between tender dates in one of the following ways:
- The period between tender dates changes from a period not exceeding 1 year to a period exceeding 1 year, OR
- The period between tender dates changes from a period exceeding 1 year to a period not exceeding 1 year.
- There is a nonqualified tender change of the period between tender dates.
- There is a change to the bond terms (other than a qualified corrective change) which would cause a disposition of the bond under § 1001 without regard to the existence or exercise of the tender right.
- The bond is purchased or acquired by or on behalf of the issuer or a true obligor which is a governmental unit or an agency or instrumentality thereof.

OR

- The bond is otherwise retired or redeemed.

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Qualified Corrective Change

"Qualified corrective change" means:

- A change that does not materially alter the rights or remedies of the holder.
- A change that corrects a term of the bond to eliminate a result that could not reasonably have been intended on the date of issue.
- A change which is necessary solely by reason of circumstances occurring after the date of which could not have been reasonably anticipated, are not related to the bond market conditions or the credit worthiness of the issue and are not within the control of the issuer, any true obligor, any holders of the bonds, any related person or any combination of the foregoing.

When Are Qualified Tender Bonds NOT Treated as Retired?

A qualified tender bond will not be treated as retired merely by reason of the existence of the tender right, a qualified tender purchase, a qualified tender change, a qualified corrective change, **or** any combination of the above. Section A2.3

When Change Occurs

Any reissuance that happens as a result of a "change" occurs on the date the terms of the bond are altered, even if the effect of that alteration occurs on a later date. Section A2.4.

Note: The qualified tender bond rules have been further clarified and modified in Notices 2008-27, 2008-41, 2008-88, and 2010-7 as discussed in Section 3 below.

Part 3

Reissuance of Bonds under Section 103

Introduction

The IRS promulgated several notices announcing its intent to issue regulations pertaining to bond reissuance. The notices were in response to severe disturbances in the municipal bond market brought on by the crisis in the subprime mortgage market that began in 2007 and continued into 2008.

These notices provided interim guidance relating to tax-exempt "qualified tender bonds." The IRS issued temporary rules clarifying events that would not cause tax-exempt "auction rate" bonds to be reissued or retired as well as special rules for commercial paper and variable rate demand obligations.

Some of the notices also had special relief for issuers to hold onto own bonds without extinguishment of debt. In order to understand the principles of debt extinguishment, it is necessary to understand the principles that apply to distinguish debt versus equity. A review of those principles applied to the concept of extinguishment of debt is discussed below

Most of these notices were amended and superseded by subsequent notices. Each of these notices is discussed in this part.

Contents

This part contains the following topics:

Extinguishment of Debt

Overview

In order to understand the considerations applied to the extinguishment of debt, it is important to understand the characteristics of debt instruments and the differences between debt and equity under federal tax law. Below is a review of those principles. A more complete discussion is in Phase II, Lesson 2, *Advanced Topics in Arbitrage*.

Introduction

The question of whether an instrument is properly treated as debt or equity for federal tax purposes has long been a contentious issue due to the absence of clear-cut rules and the need for application of subjective criteria. Nonetheless, this is important in the municipal market because an instrument must properly be characterized as debt in order for interest paid on in it to qualify for exclusion from gross income under § 103. As such, if the instrument is characterized as equity, the rules under § 103 would no longer apply and the interest paid would be taxable.

Tax-Exempt Debt

The interest on a tax-exempt debt instrument is excluded from the gross income of the holder if the instrument meets the requirements of §§ 103, 141-150. Thus, the holder may exclude amounts received on an instrument that purports to be tax-exempt if:

- The amount received is “interest.”
- The instrument is “debt” of the issuer.

Additionally, for the interest on the tax-exempt instrument to be excludible from gross income under § 103(a), the debt instrument must be issued pursuant to the borrowing power of the issuer.

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Example

The simplest example of debt is – Bank loans $1 Million to County in exchange for a note. The note is payable in 10 years and bears interest at 7%. The note is debt of the County. County is the debtor and Bank is the creditor.

Code and Regulations

Neither the Code nor the Regulations provide complete guidance on identifying an instrument as debt rather than equity. The Service has published and withdrawn proposed and final regulations discussing characteristics of debt instruments.

Section 385(b) provides that certain factors may be considered in making a determination whether a debtor-creditor relationship exists.

Section 385(c) provides that the issuer's determination of the character of an instrument is binding upon the holder. Although the parties are bound by the issuer's determination, the Service is nevertheless free to disregard the issuer's determination.

Notice 94-47

The Service issued and withdrew Regulations under § 385(c). After withdrawing the regulations, the Service published Notice 94-47, 1994-1 C.B. 357.

Notice 94-47 provides that the characterization of an instrument as debt or equity depends upon the terms of the instrument and all surrounding facts and circumstances. Some of the factors provided in Notice 94-47 in making such determination are discussed below.

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Extinguishment of Debt, Continued

Judicial Factors

The courts have often ruled on whether a particular instrument is debt or equity and have relied upon certain factors in making such rulings. Although no uniform standards have been set by the courts, the factors enunciated by the courts must also be taken into account along with the factors discussed in Notice 94-47.

The goal in applying the factors is not to count how many factors fit, but to determine the intent of the parties in structuring the instrument in a certain manner and the economic realities.

Generally speaking, instruments that bear too great a risk of repayment to the holder resemble equity more than debt.

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Factors

Some of the factors (listed in Notice 94-47 and in case law) in making such determination include, but are not limited to, the following:

- Name given to the instrument.
- Whether there is an unconditional promise to pay on demand or on a specified date the principal of the instrument.
- Whether the maturity date of the instrument is unreasonably long.
- Whether the holder of the instrument can enforce payment of principal or interest against the obligor.
- Adequacy and certainty of income.
- Whether the other creditors of the obligor are subordinated to, or preferred over, the holder of the instrument.
- Whether there is a relationship between the holders of the equity in the obligor and the holders of the instrument in question.
- The ratio of debt to equity of the obligor.

No particular factor listed above is conclusive in making the determination whether an instrument is debt or equity. The weight to be given to any factor depends upon the facts and circumstances, and the overall effect of an instrument's debt and equity features must be taken into account.

For more information on retirement of debt and considerations of debt versus equity see Phase II, Lesson 2, Advanced Topics in Arbitrage.

Notice 2008-27

Overview

Notice 2008-27, 2008-10 I.R.B. 543, 2010 along with a series of other related notices, was promulgated due to the failure of auctions in the auction rate securities market. Notice 2008-27 modifies certain reissuance standards for qualified tender bonds under Notice 88-130 and is in effect with respect to tax-exempt bonds issued on or after November 1, 2007.

It specifies to what extent auction rate bonds can be treated as qualified tender bonds for purposes of the provisions of Notice 88-130.

Auction Rate Mode

Issuers may issue tax-exempt bonds using an auction rate interest rate mode. The interest rate on auction rate bonds is reset at predetermined intervals (generally under one year) using a modified Dutch auction process. Auction rate bonds generally trade at par and are callable at par on any interest payment date at the option of the issuer. Bonds in an auction rate mode have no on-going tender options or put options to support the interest rate-setting process.

Auction rate bonds also may have interest mode conversion options similar to tender option bonds which grant to the issuer or a conduit borrower an option to change the interest rate mode on the bonds from an auction rate mode to another short-term interest rate mode or to a fixed interest rate to maturity. At the time of such conversion to another interest rate mode, auction rate bonds typically are subject to a mandatory tender for purchase in a process similar to mandatory tenders on conversions of interest rate modes used with tender option bonds.

Notice 2008-27 confirmed that auction rate bonds can be treated as qualified tender bonds for purposes of the provisions of Notice 88-130.

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Qualified Tender Bonds

Under Notice 2008-27, a qualified tender bond (as defined in section 3.2(1)), any qualified interest rate mode change (as defined in section 3.2(2)), and any qualified tender (as defined in section 3.2(3)) will not be treated as a modification under § 1.1001-3 for purposes of IRC § 103 and §§ 144-150. Therefore, a qualified tender bond will not be treated as reissued or retired solely as a result of a qualified interest rate mode change or the existence of exercise of any qualified tender.

Any interest rate variance directly related to a qualified interest rate mode change will not be treated as a modification under § 1.1001-3 and need not be tested under the change in yield rule for determining a significant modification under Regulations § 1.1001-3(3)(2).

Note these definitions and rules are superseded in Notice 2008-41.

Special Rule for Nonrecourse Debt

Solely for the purposes of applying § 103 and §§ 141-150, in applying Regulations § 1.1001-3(e)(4)(iv)(B) to determine whether a modification of the security or credit enhancement on a tax-exempt bond that is a nonrecourse debt instrument is a significant modification, such a modification is treated as a significant modification only if the modification results in a change in payment expectations under Regulations § 1.1001-3(e)(4)(iv).

Temporary Relief for Certain Waivers of Interest Rate caps on Auction Rate Bonds

Solely for purposes of § 103 and §§ 141-150, in applying Regulations § 1.1001-3(e)(2) to determine whether a modification to the yield on tax-exempt bonds that bear interest based on an auction rate constitutes a significant modification, a temporary waiver, in whole or in part, of the terms of a cap on the maximum interest rate on such auction rate bonds is disregarded to the extent that any agreement to waive such a cap and the period during which such a waiver is in effect are within the period between November 1, 2007 and July 1, 2008.

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Modification of Qualified Hedges for Arbitrate Purposes

Solely for purposes of § 148, in determining whether a modification of a qualified hedge results in a termination of the hedge under Regulations § 1.148-4(h), such a modification is not treated as a termination of the hedge if both:

- Such modification is not reasonably expected as of the date of the modification to change the yield on the affected hedged bonds over the remaining term of the hedged bonds by more than one quarter of one percent; AND
- The payments and receipts on the qualified hedge, as modified, are fully taken into account as an adjustment to the yield on those hedged bonds for arbitrage purposes under § 148.

Amendment Notice

This notice has been amended, supplemented and superseded by Notice 2008-41, discussed next.

Notice 2008-41

Overview

Notice 2008-41, 208-15 I.R.B. 742, 2008 clarifies, amends, supplements and supersedes Notice 2008-27, which modified certain special reissuance standards for qualified tender bonds under Notice 88-130.

Background

This notice is in response to auction failures and liquidity constraints in the auction rate bond sector of the tax-exempt bond market. It was promulgated to ease some of the turbulence in that market.

This notice became effective March 25, 2008 and issuers may rely on the notice for any actions taken with respect to tax-exempt bonds on or after November 1, 2007 and before the effective date of any future regulations under § 150.

It provides changes and clarifications to Notice 2008-27.

Qualified Tender Bond Rules

With respect to the qualified tender bond provisions, Notice 2008-41 does the following:

- It clarifies that the determination of whether a bond is a "qualified tender bond" is generally applied on a bond-by-bond basis, except to the extent that such test requires a determination of the weighted average maturity of the entire issue;
- It adds qualified inflation rates and qualified inverse floating rates under Regulations § 1.1275-5(c) as eligible interest rates for qualified tender bonds; AND
- It clarifies how the 90-day remarketing requirement in the definition of a qualified tender right operates but also provides a temporary 180-day remarketing requirement.

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Temporary Rule Allowing Governmental Issuers to Purchase Their Own Auction Rate Bonds

Solely for purposes of § 103 and §§ 141 through 150, a governmental issuer may purchase its own tax-exempt auction rate bond on a temporary basis without resulting in a reissuance or retirement of the purchased tax-exempt bond if it meets the following requirements:

- The governmental issuer holds the bond for not more than a 180-day period from and after the date of purchase; AND
- The governmental issuer purchases the bond before October 1, 2008.

An auction rate bond purchased by a governmental issuer pursuant to Notice 2008-41 is treated as not retired until not later than the end of this 180-day period.

An issuer may refund the bond with a refunding bond, tender the bond for purchase in a qualified tender right in its capacity as bondholder, or otherwise resell the bond during this 180-day period.

After the end of this 180-day period, however, a governmental issuer generally may not hold its own bond without causing a retirement of such bond.

Definitions

Section 3.2 of the notice provides definitions and special operating rules for terms “qualified tender bonds,” “qualified interest rate mode change,” and “qualified tender right.”

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Certain Arbitrage Rules

Section 5 of the notice provides certain special rules for applying the arbitrage rules under § 148 to tax-exempt auction rate bonds.

- Section 5.1 provides special rules for determining whether a modification of a qualified hedge results in a termination of the hedge under § 1.148-4(h).
- Section 5.2 provides that a conduit borrower's purchase of a tax-exempt auction rate bond that financed its loan to facilitate liquidity under adverse market conditions is treated as not being "related" for purposes of applying § 1.148-1(b) to program investments.
- Section 5.3 provides that any premium received by an issuer pursuant to a conversion of the interest rate on a qualified tender bond to a fixed interest rate for the remaining term of the bond to maturity in a qualified interest rate mode change is treated as additional sale proceeds (as defined in § 1.148-1(b)) of such bonds.

Certain Special Rules

With respect to Notice 2008-27 waivers to interest rate caps and certain nonrecourse debt are continued for waiver periods that are in effect between November 1, 2007 and October 1, 2008. The Notice also changed Example 2 in Notice 2008-27.

Amendment Notice

This notice has been supplemented and amended by Notice 2008-88, discussed next.

Notice 2008-88

Scope

Notice 2008-88, 2008-42 I.R.B. 933, 2008, amends and supplements Notice 2008-41, effective as of March 25, 2008, the effective date of Notice 2008-41.

Notice 2008-88 extends the time period that governmental issuers may purchase and hold a qualified tender bond (as defined in Notice 2008-41) or tax-exempt commercial paper as defined in section 2 of the notice. If either is purchased by a governmental issuer (as defined in Notice 2008-41) on a temporary basis as continuing in effect without the issue being considered retired or reissued irrespective of when the governmental issuer purchases the bond, including a purchase prior to October 1, 2008.

Interest Waiver Caps

Waivers of interest rate caps are now disregarded if the waiver agreements and waiver periods are in effect from October 1, 2008 to December 31, 2009. This effectively extended the waiver period to cover from November 1, 2007 to December 31, 2009.

Purchase of Bonds with Qualified Tender Rights

The final date for purchasing bonds with qualified tender rights eligible for the special 180-day holding period has been extended. These bonds are now also eligible if purchased from October 1, 2008 to December 31, 2009. This effectively extended the purchase period to cover purchases from November 1, 2007 to December 31, 2009.

The Notice also included changes to tax-exempt commercial paper and variable rate demand bonds with seven day put options

Amendment Notice

This notice has been supplemented and amended by Notice 2010-7, discussed next.

Notice 2010-7

Overview

Notice 2010-7, 2010-3 I.R.B. 296, 2010 modifies Notice 2008-88 to extend the expiration date from December 31, 2009 to December 31, 2010 for certain temporary rules allowing state and local government issuers to purchase and hold their own tax-exempt bonds.

Refinancing of purchased tax-exempt commercial paper during this extended period will continue to be treated a part of the same issue as the purchased tax-exempt commercial paper.

The purchase of bonds pursuant to qualified tender rights for which the special 180-day holding period applies is extended to December 31, 2010.

The treatment of certain waivers of interest rate caps on tax-exempt auction rate bonds is amended to extend the final date on which covered waivers are disregarded to December 31, 2010.

Announcement 2011-19

Introduction

This announcement describes a special closing agreement program for governmental issuers purchasing and holding their own tax-exempt variable rate bonds. This program is administered under the Tax Exempt Bonds Voluntary Closing Agreement Program (TEB VCAP).

Background

The Notices discussed above provided temporary rules that allow state and local governmental issuers to purchase and hold their own tax-exempt bonds for temporary periods without resulting in a retirement of the purchased tax-exempt bonds for purposes of §§ 103 and 141-150. The relief under these temporary rules expired on December 31, 2010.

Some issuers were unable to resell their bonds by December 31, 2010 and others continued to have the need to purchase their own tax-exempt obligations. The IRS announced that pursuant to the TEB VCAP program it would consider requests from issuers of extinguished bonds for a voluntary closing agreement to extend such relief beyond December 31, 2010.

Specific Relief

Under this VCAP program, the extinguished bonds would be treated as outstanding for purposes of § 103 and §§ 141-150 from the period of December 31, 2010, when the extension provisions of Notice 2010-7 expired, or such later time that the issuer purchased its own bonds until the bonds were remarketed or refunded under the terms of the closing agreement.

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Conditions

The closing agreement is conditioned on the issuer submitting a resolution of its government body of its intent to resell or refund the extinguished bonds. This intent must be based on the opinion of its financial advisor or other expert that such resale or refunding is likely to be successful within the stated holding period (no more than 180 days from the date the closing agreement is executed).

The issuer must represent that the bonds are outstanding for purposes of state Law, constitute legal, valid and binding obligations of the issuer under state law, and qualify as tax-exempt obligations of the issuer under § 103.

The Issuer must pay a monthly fee assessed on the par value of the outstanding bonds to be held by the issuer for the relevant holding period.

The VCAP request must be submitted no later than December 31, 2012 in accordance with the procedures under IRM 7.2.3.

Summary

Section 1001 provides that significant changes to a bond term can cause it to be reissued. This lesson provides the reissuance guidelines. The reissuance rules include:

- Regulations § 1.1001 – governing the recognition of gain or loss in the sale or disposition of property.
- Regulations § 1.1001-1(a) – exchange of property for materially differing property – which ties in certain modifications to the terms of bonds under §1001.
- Regulations § 1.1001-1(a) – provides rules to determine when a modification to bond terms result in an exchange and reissuance.

Consequences of a Reissuance can include:

- The agreement generating a new bond issuance.
- Retirement of the original bonds.
- The new issue treated as a current refunding of the original issue.
- The bondholders reporting a taxable exchange under §1001.

Regulations § 1.1001-3(a) (1) provides the rules for determining whether a modification of terms of a bond results in an exchange for purposes of Regulations § 1.1001-1(a). This regulation provides rules for:

- Defining a modification.
- Determining whether a modification is significant.

The following modifications to bond terms are deemed significant:

- Change in yield
- Change in timing of payments
- Change in obligor or security
- Change in nature of a debt instrument
- Change in accounting or financial covenants

Regulations § 1.150-1 provides requirements before a bond term modification can be deemed a refunding. To be a refunding issue the obligor of the refunding issue must be the same or related to the obligor of the refunded issue.

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Regulations §§ 1.1001-3 and 1.150-1 are coordinated with each other to determine whether a significant modification to a bond's terms triggers:

- A reissuance, a refunding, or a new bond issue.

Regulations § 1.1001-3(f) (1) provides rules to test whether or not a group of modifications to a bond's terms is significant.