

TEB Phase III - Lesson 2

Reissuances

Overview

Introduction

This lesson discusses the reissuance rules. The reissuance rules govern situations in which the existing bonds are deemed to have been retired and new bonds issued in their place. Such a deemed retirement and reissuance can occur when the terms of a bond are changed after the bond's original issuance or when the issuer acquires and resells its own bonds.

This lesson explains how to determine if a reissuance has occurred and what consequences result from the reissuance. This lesson also discusses certain related topics such as certain temporary relief provided to issuers that acquire and hold their own bonds.

Purpose

The purpose of this lesson is to identify and understand circumstances that result in bond reissuances pursuant Notices 88-130 and 2008-41 and Treas. Reg. § 1.1001-3.

Continued on next page

Overview, Continued

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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Contents

This lesson contains the following topics:

Topic	See Page
Overview	1
Introduction to Reissuances	3
Part 1: General Rules for Retirement of Tax-Exempt Bonds	5
Part 2: Significant Modification under §1.1001-3	13
Part 3: Qualified Tender Bonds and Other Special Rules	41
Summary	51

Introduction to Reissuances

Background

Since 1988, Notice 88-130 has generally provided that a tax-exempt bond is retired when: (1) there is a change to the terms of the bond that results in a disposition of the bond for purposes of § 1001, or (2) the bond is acquired by or on behalf of the issuer in a manner that liquidates the bondholder's investment. If the parties continue to perform under the terms of the bond (or modified terms of the bond) following one of these events, the bond is treated as a new bond that is different from the original bond. Notice 88-130 also provides special rules for qualified tender bonds.

In *Cottage Savings Association v. Commissioner*, 111 S. Ct. 1503 (1991), the Supreme Court considered whether an exchange of one participation interest in mortgages for another participation interest in different mortgages was a taxable exchange of property under § 1001. The Court considered the issue based on the standard of “material difference” provided by § 1.1001-1(a). 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 § 1.1001-3 were issued in 1992 to provide guidance regarding when modifications to bond terms would constitute a taxable exchange of one bond for another. These were greeted with many comments and suggestions by taxpayers, and final regulations were issued in September 1996. Although the preamble to the final regulations confirmed that Notice 88-130 would continue to apply, § 1.1001-3 established the rules by which issuers would thereafter determine whether a disposition had occurred under § 1001 when the terms of a bond are modified.

In 2008, the Service published Notice 2008-41 which provides a simplified version of the rules for determining whether a tax-exempt bond, including a qualified tender bond, is reissued. These rules are similar to but not identical to those in Notice 88-130, and issuers generally may choose which of these two notices they wish to apply. Notice 2008-41 and other notices also provided limited relief related to the contemporaneous financial crisis.

Continued on next page

Introduction to Reissuances, Continued

How a Reissuance Works

City M has \$20,000,000 principal amount outstanding from a 1984 bond issue yielding 9 percent. In 1990, 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.

Part 1: General Rules for Retirement of Tax-Exempt Bonds

Overview

Introduction Notices 88-130 and 2008-41 provide the general rules for determining when a tax-exempt bond is retired. In some cases, when parties continue to perform under the terms of the bond (or modified terms of the bond) following a retirement, the bond is treated as a new bond that is different from the original bond and said to have been reissued.

Scope The rules under Notices 88-130 and 2008-41 for determining when a tax-exempt bond is retired apply only for purposes §§ 103 and 141 through 150.

Contents This part contains the following topics:

Topic	See Page
Overview	5
Section 1: General Rules for Retirement	6
Section 2: Consequences of Reissuance	10

General Rules for Retirement

Reissuance Rules

Notices 88-130 and 2008-41 each generally provide that, for purposes of §§ 103 and 141 to 150, a tax-exempt bond is retired on the first date on which:

- A significant modification to the terms of the bond occurs under §1.1001-3,
- The bond is purchased or otherwise acquired by or on behalf of the issuer in a manner that liquidates the bondholder's investment, OR
- The bond is otherwise retired or redeemed at maturity.

Notices 88-130 and 2008-41 also provide special rules for qualified tender bonds that are discussed in Part 3 of this lesson.

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General Rules for Retirement, Continued

Significant Modification under §1.1001-3

In general, § 1.1001-3 employs a significant modification standard to determine whether modifications to a debt instrument are significant enough to cause the debt instrument to be treated as reissued or exchanged for purposes of § 1001. A modification under § 1.1001-3 includes both amendments to the terms of an existing debt instrument and actual exchanges of existing debt instruments for different debt instruments. The determination of whether a resulting debt instrument is treated as a reissued new debt instrument or a continuation of the original debt instrument depends on whether it represents a “significant modification” of the original debt instrument, as defined in § 1.1001-3. These rules are discussed in detail in Part 2 of this lesson.

In addition to causing the bond to be retired and reissued for purposes of §§ 103 and 141 to 150, a significant modification under § 1.1001-3 is also a realization event for the bondholders. Thus, under § 1001, bondholders may recognize gain or loss on the exchange of the original bond for the new bond.

As a technical matter, Notice 88-130 does not refer to § 1.1001-3 because Notice 88-130 predates § 1.1001-3. The notice actually refers to a disposition under § 1001 rather than to a significant modification under §1.1001-3. Nevertheless, the reference to § 1.1001-3 is accurate for alterations occurring after the effective date of § 1.1001-3. In contrast, Notice 2008-41 specifically refers to § 1.1001-3.

Section 1.1001-3 applies to alterations of the terms of debt instruments on or after September 24, 1996. Taxpayers may also rely on § 1.1001-3 for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

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General Rules for Retirement, Continued

Extinguishment A bond may be treated as retired when it is acquired by or on behalf of its issuer. Retirement under these circumstances is sometimes referred to as extinguishment, because the retirement is the result of a merger of the interests of the issuer and the holder, which causes the bond to be extinguished. A bond retired in this way is only reissued if the issuer or its agent resells the bond to a new holder.

Notices 88-130 and 2008-41 treat a conduit borrower as the issuer of the bond for this purpose, but only if the conduit borrower is a governmental unit. Thus, the acquisition of a bond by a conduit borrower that is a governmental unit may result in the bond's extinguishment. Acquisition of a bond by a conduit borrower that is a private party (for example, a substantial user of an exempt facility financed under § 142), however, will not result in the bond's extinguishment.

Notices 88-130 and 2008-41 provide an exception to the extinguishment rule for bonds acquired by a third-party guarantor or a liquidity facility provider pursuant to the terms of the guarantee or liquidity facility. Absent this exception, such acquisitions might be considered acquisitions on behalf of the issuer, in which case the bonds would be retired.

Otherwise Retired or Redeemed Unsurprisingly, bonds are considered retired on their scheduled maturity date. Bonds retired in this way are not reissued.

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General Rules for Retirement, Continued

Qualified Tender Bonds

For certain tax-exempt bonds, called qualified tender bonds, Notices 88-130 and 2008-41 provide special rules for determining when such bonds are retired. Qualified tender bonds have characteristics that could, absent an exception, result in retirement under the general rules above. In particular, the interest rate of a qualified tender bond may be modified one or more times prior its maturity in manner that could qualify as a significant modification under § 1.1001-3. Additionally, in connection with such an interest rate change, the issuer or its agent may acquire the bonds under circumstances that result in the bond's extinguishment. Under the exceptions for qualified tender bonds provided in Notices 88-130 and 2008-41, these events do not result in the retirement of a qualified tender bond. Qualified tender bonds and the special rules for such bonds are discussed in Part 3 of this lesson.

Effective Dates

Notice 88-130 generally applies to tax-exempt bonds originally sold after December 14, 1988.

Notice 2008-41 generally applies to actions taken with respect to tax-exempt bonds on or after November 1, 2007. Notice 2008-41 also provides that issuers may continue to rely on Notice 88-130.

Consequences of Reissuance

Why should Issuers Care about the Effects?

Let's return to City M, which was unable to pay debt service on bonds issued in 1984 with a yield of 9 percent. The bondholders had agreed to lower the interest rate on the bonds to 6 percent and to extend the maturity date by 5 years. 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, the 1990 bonds may now be subject to the current tax laws, including rebate. Since the yield on the 1990 reissued bonds is lower than the yield on the original 1984 bonds, City M may need to rebate to the U.S. government any earnings on the investments in the reserve fund over the yield on the 1990 bonds.
- Second, because the reduction in City M's interest rate from 9 percent to 6 percent qualifies as a significant modification under § 1.1001-3, the bondholders may have to take gain or loss from the exchange into account on their tax returns.

Results of a Reissuance

The consequences:

- In the case of a significant modification to the terms of the bond under §1.1001-3, the original bonds are retired and new bonds are issued at the time the issuer and holder enter into the agreement to change a term of a debt instrument, even if the change in the term is not immediately effective.
- In the case of an extinguishment, the original bonds are retired when acquired by or on behalf of the issuer, and new bonds are considered to be issued if and when the issuer resells the bonds into the market.
- The new issue *may* be treated as a "current refunding" of the original bond issue.

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Consequences of Reissuance, Continued

Results of a Reissuance, (continued)

- In the case of a significant modification to the terms of the bond under § 1.1001-3, the bondholders may 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 (e.g., 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).
-

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 of reasons why this would be a favorable result to the issuer. For example, a current refunding may not require volume cap or TEFRA approval.

Regardless of whether it meets the definition of a current refunding, the reissued bond must still qualify as a tax-exempt obligation. Thus, the new bond issue must meet the tax laws in effect at the time of the reissuance.

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.

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Part 2: Significant Modification under § 1.1001-3

Overview

Introduction Section 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 § 1.1001-1(a).

Section 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 Section 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.

Section 1.1001-3 does not apply to exchanges of debt instruments between holders.

Section 1.1001-3 does not apply to determine whether tax-exempt bonds that are qualified tender bonds are reissued for purposes of §§ 103 and 141 to 150.

Continued on next page

Overview, Continued

Contents This part contains the following topics:

Topic	See Page
Overview	13
Section 1: Modifications to Debt Instruments	15
Section 2: Significant Modifications	21

Section 1: Modifications to Debt Instruments

General Rules for Definition of Modification

Alteration of Terms

Section 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 - Operation of Terms

Section 1.1001-3(c)(1)(ii) provides that except as provided in § 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.

Exceptions

Section 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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General Rules for Definition of Modification, Continued

Definition of Unilateral Option

Under § 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:
 - o the other party,
 - o a person related to the other party, OR
 - o 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:
 - o a de minimis amount,
 - o a specified amount, OR
 - o an amount based on a formula using objective financial information.
-

Options Flowchart

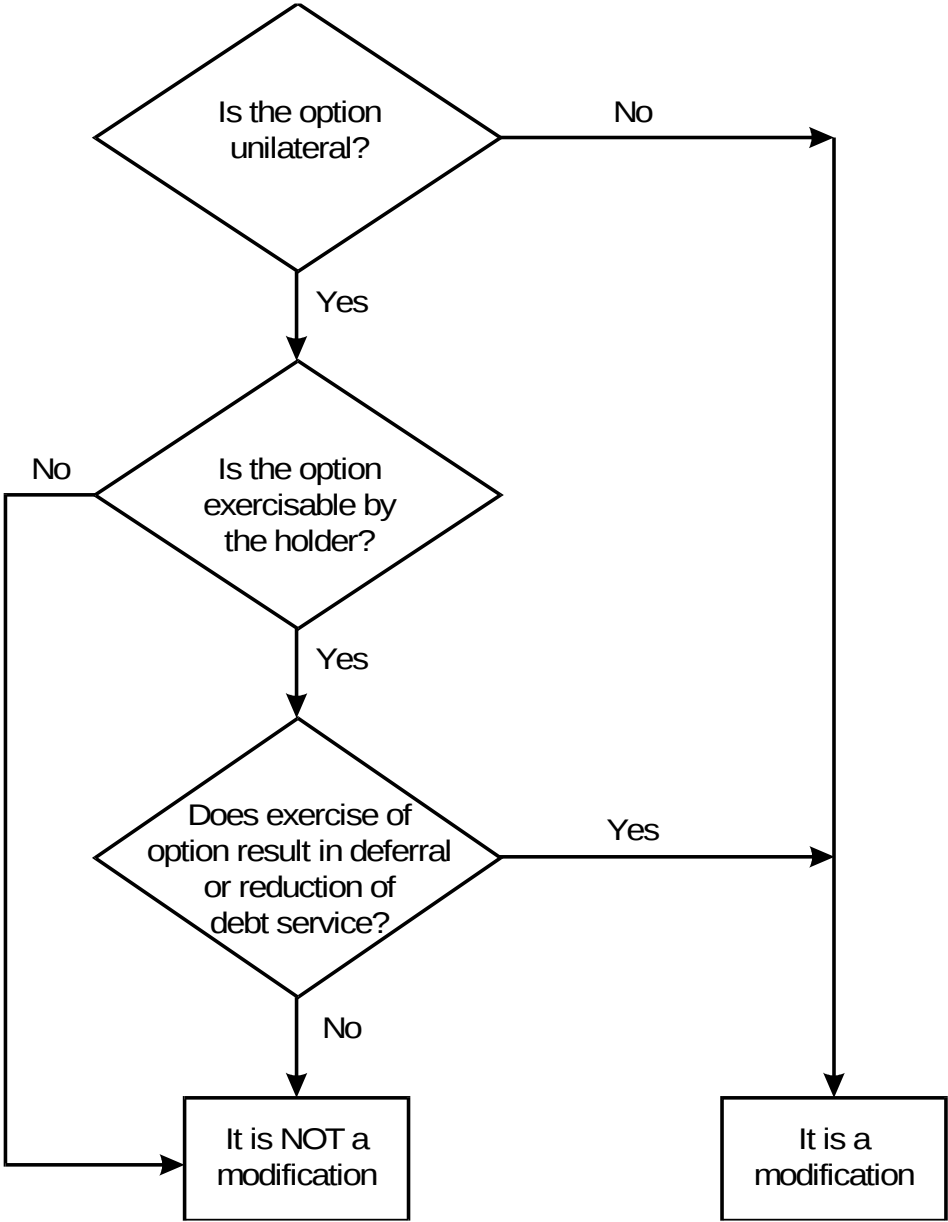
After you have determined whether or not the option is unilateral, use the flowchart in Figure A-1 to determine whether or not the alteration resulting from the exercise of the option is a modification.

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General Rules for Definition of Modification, Continued

Figure A-1

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



General Rules for Definition of Modification, Continued

Failure to Perform

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.

Notwithstanding § 1.1001-3(c)(1), 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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General Rules for Definition of Modification, Continued

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 § 1.1001-3(c)(4)(i), the issuer's failure to make the scheduled payment is not a modification. In addition, according to § 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(3)(A). However, as soon as the parties reach agreement regarding new terms, these new terms may constitute a modification.

See Treas. Reg. §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 § 1.1001-3(c)(2), thus such a decrease in the interest rate is not a modification.

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General Rules for Definition of Modification, Continued

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)(3)(i), is not a unilateral option. Thus, the alteration is described in § 1.1001-3(c)(2)(iii), 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 § 1.1001-3(c)(2)(iii). Thus, the change in interest rate is a modification.

The General Rule Revisited

Remember that the general rule of §1.1001-3(b) states that a modification that is not a **significant** modification is not an exchange for purposes of § 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	Section 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 § 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	Section 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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Continued on next page

Overview, Continued

Contents

This part contains the following topics:

Topic	See Page
Overview	21
Change in Yield	23
Change in Timing of Payments	25
Change in Obligor or Security	27
Coordination of §§ 1.1001-3 and 1.150-1	30
Change in Security or Credit Enhancement	34
Change in the Nature of a Debt Instrument	36
Change in Accounting or Financial Covenants	37
How to Use the Rules to Test for Significance	38

Change in Yield

Applicability

Section 1.1001-3(e)(2) applies to:

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

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.
-

Adjusted Issue Price

Section 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 instrument from the date of the modification
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Change in Yield, Continued

Example 6

A debt instrument issued at par has an original maturity of 10 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 § 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 §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. *See § 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
- The time period between the modification and the actual deferral of payments

See § 1.1001-3(e)(3)(i).

Safe Harbor

Section 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 §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 § 1.1001-3(f)(5), the term “obligor” means the issuer of the bonds. Section 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, § 1.1001-3(f)(5)(iv) states that the terms “conduit loan” and “conduit borrower” have the same meanings as in § 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	Section 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. Note: Proposed Reg. 165706-01, April 10, 2002, would revise §1.150-1(d)(2)(ii) to define “obligor” as the: • Actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment • Obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in §1.148-1) does not include the ultimate recipient of the loan (e.g., the homeowner, the student)

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Change in Obligor or Security, Continued

**Recourse vs
Nonrecourse
Debt**

Section 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.

Section 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**

Section 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 § 1.1001-3(e)(4)(i)(C) if the:

- New obligor acquires substantially all of the assets of the original obligor,
 - Transaction does not result in a change in payment expectations, AND
 - Transaction does not result in a significant alteration.
-

**Exception for
Tax Exempt
Bonds**

Section 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
 - 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.

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Change in Obligor or Security, Continued

Nonrecourse Debt

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

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)) 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 §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 §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 §§ 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 § 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 § 1.150-1(d)(2)(ii). Let’s turn to § 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).

Why Do We Care?

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

Obligor under § 1.150-1

Section 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 § 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 Obligor	Under §1.1001-3	Under §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 § 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).		

Continued on next page

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

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 §§ 1.1001-3 and 1.150-1?

A: Under § 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 § 1.150-1.

Continued on next page

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

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 §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 with § 1.1001-3 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. Section 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 § 1.1001-3, then we would have to verify whether the reissued bond may be classified as a refunding bond under § 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.

Continued on next page

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

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

Under § 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: Section 1.1001-3 does not apply to these bonds because the original bonds have been retired and new bonds have been issued. Under § 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, § 1.1001-3 does not apply because the original bonds have been retired and new bonds have been issued.

Under § 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 Section 1.1001-3(e)(4)(iv)(A) states that a modification that releases, substitutes, adds, or otherwise alters the collateral for, 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 Section 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 fungible (for example, government securities or financial instruments of a particularly type and rating)
- Substitution of a similar commercially available credit enhancement contract
- Improvement to the property securing the obligation

Continued on next page

Change in Security or Credit Enhancement, Continued

Change in Priority of a Debt

Section 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 modification and is adequate after the modification, or
- 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 § 1.1001-3(e)(4)(vi).

Change in the Nature of a Debt Instrument

General Rule Section 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.

Exceptions Section 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
- Issuer places in escrow government securities or tax-exempt government bonds that are expected to pay the debt service.

Section 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 significant 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.
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How to Use the Rules to Test for Significance

General Rule Section 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 § 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 § 1.1001-3(e)(2) through (5) 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 § 1.1001-3(f)(1)(ii).*

Modifications That Do Not Meet the Significance Tests If a modification is of the same type under § 1.1001-3(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 § 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.

Cumulative Effects of Modification Section 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.

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How to Use the Rules to Test for Significance, Continued

Modifications of Different Terms

Section 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 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 under § 1.1001-3(e)(1), the general rule provides that all modifications (other than modifications in 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.

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 8th year, the holder of the bond pays the issuer to waive the issuer's right to call the bond at the end of the 10th 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 § 1.1001-3(e) does not specifically address this change, its significance must be evaluated under the general rule of § 1.1001-3(e)(1). *See § 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 § 1.150-1(d)(2) and, if applicable, the transitional rules of § 1313(a) are still required.

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Part 3 - Qualified Tender Bonds and Other Special Rules

Overview

Introduction

In Part 1, we learned that Notices 88-130 and 2008-41 provide the general rules for determining whether a tax-exempt bond is retired for purposes of §§ 103 and 141 through 150. Under these rules, a tax-exempt bond is retired when a significant modification to the terms of the bond occurs under § 1.1001-3 or when the bond is purchased or otherwise acquired by or on behalf of the issuer in a manner that liquidates the bondholder's investment.

Notices 88-130 and 2008-41 also provide special rules for qualified tender bonds. Qualified tender bonds have characteristics that could, absent an exception, result in retirement under § 1.1001-3 or extinguishment principals. Both notices define a qualified tender bond and set out the special retirement rules for which a qualified tender bond is eligible. Section 1 of this Part 3 will discuss different features of tax-exempt bonds that make necessary an exception to the general rules for retirement. Section 2 will define qualified tender bonds and discuss the exceptions for which they are eligible.

In addition, Notices 2008-41, 2008-88, and 2010-7 provide certain limited rules to help issuers weather the 2008 financial crisis. Section 3 of this Part 3 describes these rules.

Contents

This part contains the following topics:

Topic	See Page
Overview	41
Section 1: Interest Rate Modes and Tender Options	42
Section 2: Qualified Tender Bonds	45
Section 3: Special Rules Related to the 2008 Financial Crisis	49

Interest Rate Modes and Tender Options

General

We know that issuers sometimes issue tax-exempt bonds with variable rates, for example a rate that varies based on an index, and that they sometimes issue bonds with fixed rates. Some bonds, called multi-modal bonds, have terms that permit the issuer to switch from one interest rate mode to another. For example, the bonds may start out with an interest rate that varies based on an index and then, upon the issuer's exercise of its option under the terms of the bond, switch to a fixed rate until maturity.

Commonly, at the time the issuer exercises its option to switch the interest rate mode on the bonds, the holder will have an option or obligation to tender its bonds to the issuer for purchase; that is, the holder can or must sell its bonds back to the issuer. Following such a tender, the issuer will resell the tendered bonds to new bondholders. When the dust settles, the issuer pays interest under the new interest rate mode and only investors who accept the new interest rate mode hold the bonds.

Absent an exception to the general rules in Notices 88-130 and 2008-41 for retirement of a bond, these two features—the change in interest rate mode and the tender—could cause the bonds to be reissued. Depending on the facts, the change in interest rate mode could be a significant modification under § 1.1001-3. Also, the fact that the issuer or its agent acquires the bonds pursuant to the tender could result in the extinguishment of the bonds.

An issuer may contract with third parties to facilitate various parts of these operations. For example, the issuer will generally use a remarketing agent to resell the bonds after a tender. The issuer will also typically contract with a credit facility provider to improve the credit rating on the bonds and with a liquidity facility provider to provide the cash necessary to repurchase the bonds upon tender.

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Interest Rate Modes and Tender Options, Continued

Tender Option Mode

One common interest rate mode employed with tax-exempt bonds is a tender option mode. Bonds that use such a mode are sometimes called tender option bonds or variable rate demand obligations. Under the terms of a bond operating in a tender option mode, the interest rate resets at prescribed intervals (typically every 7 days) through a process of reselling the bonds at current market rates. The first step in the process is that, at the end of the prescribed interval (sometimes called the tender period), the holder may or must tender the bonds for purchase by the issuer or its agent. Next, an agent of the issuer, called a remarketing agent, resells the bonds into the market at the lowest interest rate available for those bonds. By automatically repeating at the end of every tender period, this process resets the interest rate on the bonds to the current market rate for every tender period.

It is important to note that a tender option mode is just one possible interest rate mode on a bond and that the terms of a multi-modal bond may give the issuer the option to change from a tender option mode to other interest rate modes, such as a variable rate or a fixed rate to maturity. Additionally, the terms of a multimodal bond may give the issuer an option to change from a tender option mode with one tender period to another tender option mode with a different tender period. Generally, each such change in interest rate mode triggers a bondholder's right or requirement to tender the bond for purchase by the issuer or its agent.

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Interest Rate Modes and Tender Options, Continued

Multi-Modal Bonds, Tender Option Modes, and §1.1001-3

It is also important to note that the analysis under § 1.1001-3 of the process for resetting the interest rate under a tender option mode is different from the analysis under § 1.1001-3 of the switch from one interest rate mode to another, even though both may trigger the bondholder's right or requirement to tender the bond for purchase.

Generally, under § 1.1001-3, an alteration of a legal right or obligation that occurs by operation of the terms of the bonds is not a modification. However, 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 the option is a unilateral option.

Because the resetting of the interest rate under a tender option mode is an alteration to a legal right or obligation that occurs by operation of the terms of the bond, it is not a modification under § 1.1001-3 and, therefore, the bond is not retired under Notices 88-130 and 2008-41.

On the other hand, the switch from one interest rate mode to another is an alteration that results from the exercise of an option provided to the issuer to change a term of a debt instrument and, therefore, is a modification under § 1.1001-3 unless the option is a unilateral option. Assuming that there is a modification (i.e., that the issuer's option is not unilateral) and that it is significant under § 1.1001-3, the change in interest rate mode will cause the bonds to be retired unless the bonds are qualified tender bonds.

Qualified Tender Bonds

Overview

We have already discussed the general rules provided in Notices 88-130 and 2008-41 for determining when a tax-exempt bond is retired. These notices also provide special rules for qualified tender bonds, although each notice provides a slightly different version of these rules. The purpose of these rules is to prevent certain features of qualifying multi-modal bonds or tender option bonds from resulting in retirement of the bonds.

Generally, Notice 88-130 applies to tax-exempt bonds originally sold after December 14, 1988. Notice 2008-41 applies to actions taken with respect to tax-exempt bonds on or after November 1, 2007, regardless of when the bonds were issued. Notice 2008-41 also provides that issuers may continue to rely on Notice 88-130.

We will discuss the rules in each notice independently.

Definition of Qualified Tender Bond in Notice 88-130

Under Notice 88-130, a qualified tender bond is any bond for which all of the following are true:

- The bond is subject to a tender right. “Tender right” means, on one or more tender dates before the maturity date and pursuant to the terms of the bond, the holder of the bond may or must tender the bond for purchase or redemption at par (plus accrued interest).
 - For all interest accruing prior to the first tender date, the rate is set on or after the sale date at the lowest rate that would enable the bond to be marketed at par (plus any accrued interest) on the date of issue. For interest accruing between tender dates, under the terms of the bonds the interest rate is reset for each period at the lowest rate that would enable the bond to be remarketed at par (plus any accrued interest) at the beginning of the period. The interest accruing for each period may be subject to a minimum and/or maximum rate if the minimum and/or maximum rate is not designed to front-load or back-load interest.
 - All interest on the bond is actually and unconditionally due at periodic intervals of 1 year or less.
 - The maturity date is no later than the earlier of: (1) 35 years after the issue date; or (2) the latest date reasonably expected (as of issue date) to be required to carry out the governmental purpose of the issue.
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Qualified Tender Bonds, Continued

Special Rules for Qualified Tender Bonds in Notice 88- 130

The general rules under Notice 88-130 for determining when a tax-exempt bond is retired do not apply to a qualified tender bond. Instead, a qualified tender bond is retired only when one of the following occurs:

- The qualified tender bond is acquired by or on behalf of the issuer or a true obligor in a manner that liquidates the bondholder's investment.
- The qualified tender bond is retired or redeemed at maturity.
- There is a change to the terms of the qualified tender bond (other than a qualified corrective change) that is a significant modification under § 1.1001-3 without regard to the existence or exercise of a tender right.
- In a transaction, there is a change to the terms of the bonds (other than a qualified corrective change) in connection with a qualified tender change that alters the period between tender dates from less than a year to more than a year or vice versa.
- There is a change in the period between tender dates that is not a qualified tender change.

Furthermore, notwithstanding the rules above providing for retirement of a qualified tender bond, a qualified tender bond is not treated as retired merely because of any one or more of the following:

- The existence of the tender right
- A qualified tender purchase
- A qualified tender change
- A qualified corrective change

The special rules for qualified tender bonds in Notice 88-130 are stated here in summary fashion. Additionally, Notice 88-130 contains an extensive and detailed list of definitions necessary to apply these rules.

Continued on next page

Qualified Tender Bonds, Continued

**Definition of
Qualified
Tender Bond in
Notice 2008-41**

Under Notice 2008-41, a qualified tender bond is any bond for which all of the following are true:

- The bond is subject to a tender right or a tender requirement that allows or requires a bondholder to tender the bond for purchase in circumstances prescribed under the terms of the bond.
- For each interest rate mode allowed under the terms of the bond considered separately, the bond bears interest during the term of that mode at one of the following rates: (1) a fixed rate; (2) a qualified floating rate under §1.1275-5(b); or an eligible objective rate under §1.1275-5(c)(5).
- Interest is unconditionally payable at periodic intervals at least annually.
- The maturity date is no longer than the lesser of: (1) 40 years after the issue date; or (2) the latest date reasonably expected as of the issue date to be necessary to carry out the governmental purpose of the issue.

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Qualified Tender Bonds, Continued

Special Rules for Qualified Tender Bonds in Notice 2008- 41

Under Notice 2008-41, qualified tender bonds are given the following exceptions to the general rules for determining when a tax-exempt bond is retired:

- A qualified tender bond is not retired solely as a result of: (1) a qualified interest rate mode change or any interest rate variance directly resulting from a qualified interest rate mode change, or (2) the existence or exercise of any qualified tender right.
- A qualified tender bond purchased by or on behalf of a governmental issuer pursuant to a qualified tender right and held for no more than 90 days is treated as not retired as a result of the qualified tender right.

Notice 2008-41 provides the following definitions:

- “Qualified interest rate mode change” means a change in the interest rate mode that is authorized under the original terms of the bond if such terms require that the bond be purchased and resold at a price equal to par upon conversion to a new interest rate mode. Upon conversion to a fixed rate mode for the remaining term of the bond, the bond can be resold at a premium or discount from par, but any premium received must be treated as additional sale proceeds under § 148.
 - “Qualified tender right” means a tender right for the purchase of a bond that: (1) is authorized under the original terms of the bond; (2) involves either an optional tender right or a mandatory tender requirement which allows or requires the bondholders to tender the bond for purchase on at least one tender date before the maturity of the bond; (3) entitles a tendering bondholder to receive a purchase price equal to par (including accrued interest); and (4) requires the issuer or its remarketing agent to use at least best efforts to remarket the bond upon purchase pursuant to the tender right.
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Special Rules Related to the 2008 Financial Crisis

2008 Financial Crisis

The IRS promulgated several notices in response to severe disturbances in the municipal bond market brought on by the crisis in the subprime mortgage market that began in 2007. These notices provided certain special rules for reissuance intended to help issuers weather those market disturbances. These special rules:

- Temporarily extended the maximum period under Notice 2008-41 during which an issuer may hold its qualified tender bond repurchased pursuant to a qualified tender right from 90 days to 180 days.
- Temporarily permitted issuers to purchase their own auction rate bonds without causing the bonds to be retired.
- Provided that, in applying § 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 § 1.1001-3(e)(4)(vi).
- Temporarily provided that, in applying § 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 of the terms of a cap on the maximum interest rate on such auction rate bonds is disregarded.

For more information about these rules, see Notices 2008-41, 2008-88, and 2010-7.

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Summary

Review of Lesson 2

Notices 88-130 and 2008-41 provide the rules for determining whether a tax-exempt bond is retired for purposes of §§ 103 and 141 through 150. They generally provide that a tax-exempt bond is retired on the first date on which:

- A significant modification to the terms of the bond occurs under § 1.1001-3,
- The bond is purchased or otherwise acquired by or on behalf of the issuer in a manner that liquidates the bondholder's investment, or
- The bond is otherwise retired or redeemed at maturity.

In some cases, when parties continue to perform under the terms of the bond (or modified terms of the bond) following a retirement, the bond is treated as a new bond that is different from the original bond and said to have been reissued. Consequences of a reissuance can include:

- Retirement of the original bonds
- The issuance of new bonds
- Retesting of the new bonds under §§ 103 and 141 through 150
- The new issue treated as a current refunding of the original issue
- The bondholders reporting a taxable exchange under § 1001

Under Notices 88-130 and 2008-41, §1.1001-3 applies to determine whether a modification of the terms of a bond results in retirement of the bond. 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

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Summary, Continued

**Review of
Lesson 2**
(continued)

Section 1.150-1(d) defines 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.

Notices 88-130 and 2008-41 also provide special rules for determining when a qualified tender bond is retired. Generally, the purpose of these rules is to prevent certain features of qualifying multi-modal bonds or tender option bonds from resulting in retirement of the bonds.

Notices 2008-41, 2008-88, and 2010-7 provide certain limited rules for reissuance of tax-exempt bonds in response to the 2008 financial crisis.
