

## Proposed Reissuance Regulations

### Hawkins Update

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#### **I. Introduction**

The Department of the Treasury, Internal Revenue Service, released proposed regulations adding new section 1.150-3 (the “Proposed Regulations”), as well as certain conforming amendments to section 1.1001-3(a)(2) of the existing Treasury Regulations. The Proposed Regulations address the subject of “reissuance” in connection with issues of tax-exempt obligations. When a reissuance is determined to have occurred, the affected debt instrument is treated as retired for tax purposes and a new instrument issued in its place. The finding of a reissuance has actual tax consequences to both the holder, whose investment in the bond has been extinguished and who may hold a newly-issued bond, and the issuer, who could have to revisit the yield on the original instrument, make accelerated rebate and yield reduction payments, if any, on the retired obligation, and give effect to any changes in applicable law enacted after the date the original bond was issued.

The Proposed Regulations generally follow the guidance set forth in IRS Notice 2008-41, 2008-1 CB 742 (the “2008 Notice”), with certain refinements, and, according to the preamble, are expected to obsolete both Notice 88-130, 1988-2 CB 543 (the “1988 Notice”), and the 2008 Notice.

#### **II. IRS Notice 2008-41**

The 2008 Notice, published during the financial crisis of 2008, was intended to coordinate the 1988 Notice, which generally provided guidance in respect of tax-exempt qualified tender option bonds (“QTOBs”), with certain Treasury Regulations published in 1996 in respect of section 1001 of the Internal Revenue Code, as amended from time to time (the “1996 Regulations”), which provided guidance for situations involving modifications of debt instruments and the consequences of such modifications relative to the continuation or extinguishment of the original instrument. The 1996 Regulations apply to modifications of debt instruments in general. As reiterated in the preamble to the Proposed Regulations, the 2008 Notice afforded issuers the option of applying the provisions of the 1988 Notice or the 2008 Notice in circumstances involving changes to the terms of an existing debt instrument.

The 2008 Notice clarified that a tax-exempt bond is generally retired (a) upon the occurrence of a “significant modification,” as determined in accordance with the provisions of the 1996 Regulations, (b) when the bond is acquired by or on behalf of the issuer, and not remarketed within a certain time period (generally 90 days), or (c) when the bond is otherwise redeemed or retired. The 2008 Notice provided that the purchase of a tax-exempt bond by a third-party guarantor or liquidity facility provider is not treated as a purchase or other acquisition by or on behalf of a governmental issuer. Finally, the 2008 Notice allowed qualified interest mode changes in respect of a QTOB to be implemented without resulting in a reissuance of the instrument.

#### **III. Proposed Regulations**

##### **A. Circumstances in which a Tax-Exempt Bond will be Considered Retired**

The Proposed Regulations provide that, unless an exception applies, a tax-exempt bond is treated as retired for tax purposes in the following circumstances:

- 1) a significant modification to the terms of the instrument occurs under the 1996 Regulations;

- 2) the issuer (or agent acting on the issuer's behalf) acquires the bond in a manner that liquidates or extinguishes the bondholder's investment in the bond; or
- 3) the instrument is otherwise redeemed (e.g., retired at maturity).

The Proposed Regulations define "issuer" to mean the actual issuer of the bonds, including any "related party" to the issuer. "Related party," when used in the context of a state or local governmental unit, includes any person who is a member of the same "controlled group" (i.e., an entity with control over both the governing body of a governmental unit and use of such unit's funds or assets, and any other entity controlled by the same controlling entity). This definition of "issuer" allows private activity bonds to be acquired by the conduit borrowers in respect of such bonds without the bond being considered retired (assuming the conduit borrower is not related to the actual issuer).

## **B. Consequences of Bond Retirement**

The Proposed Regulations clarify that if a bond is treated as retired under the provisions of the 1996 Regulations as a result of one or more significant modification to the original terms of such bond, the new bond is considered issued on the date that a significant modification is effected, consistent with the provisions of section 1.1001-3.

If a bond is acquired by (or on behalf of) the issuer in a manner that liquidates or extinguishes the bondholder's investment and the issuer subsequently resells the acquired bond, the Proposed Regulations provide that such bond will be considered newly-issued on the date of resale, provided the bond is resold not more than 90 days after the date it is acquired. If the retired bond is not resold, as described above, it is considered to have been permanently retired.

If a bond is acquired by the issuer and subsequently resold to an investor, the preamble to the Proposed Regulations raises the question of whether the newly issued bond may be properly considered a current refunding of the acquired bond. For example, if the issuer (or, under the provisions of section 1.150-(d), the conduit borrower) of the new bond is the same person or a related party to the issuer (or conduit borrower) of the original bond, the new bond would be considered to have been issued for the purpose of refunding the original bond.

## **C. Three Exceptions to a Finding of Retirement**

The Proposed Regulations provide three exceptions to the determination that a bond is retired. Two of these exceptions apply solely to QTOBs, and are necessary due to certain features of QTOBs; the third applies to all tax-exempt bonds.

A QTOB is defined as a tax-exempt bond that (i) bears interest by its terms during each interest rate mode at a fixed rate, a qualified floating rate under section 1.1275-5(b), or an objective rate that is permitted under section 1.1275-5(c)(5), (ii) has a qualified tender right, (iii) has a stated maturity date that is not more than 40 years after its issue date, and (iv) pays interest at periodic intervals of not more than one year. A "qualified tender right" is defined as a right or obligation of a holder of a bond to tender the bond for purchase on a date at least one date before the stated maturity date of the bond and for a purchase price equal to par plus any accrued interest. The tendered bond is then either redeemed by the issuer; or issuer (or its remarketing agent) uses reasonable best efforts to resell the bond within the 90-day period beginning on the date the bond is tendered. The purchase price of the bond upon resale is equal to par plus accrued interest, if any.

The first exception for a QTOB relates to a holder's ability to put the bond in connection with a qualified tender right, the exercise of which may result in a reissuance under the 1996 Regulations. The Proposed Regulations state that both the existence and exercise of a qualified tender right are disregarded for purpose of the 1996 Regulations; that is to say, the exercise of a qualified tender right is treated as a unilateral option and will not result in the bond being retired.

The second exception for a QTOB relates to the acquisition of the bond by or on behalf of the issuer pursuant to the operation of a qualified tender right. So long as the acquisition is pursuant to a qualified tender right and neither the issuer or its agent (including a remarketing agent), holds the bond for longer than 90 days, under the Proposed Regulations, the acquisition will not result in the acquired bond being retired.

The third exception applies to all tax-exempt bonds. Bonds acquired by a third-party guarantor or liquidity facility provider will not result in the bond being retired if the acquisition is pursuant to the terms of the guarantee or liquidity facility and the guarantor or liquidity facility provider is not related (as described above) to the issuer.

#### **D. Effective Dates**

The Proposed Regulations are stated to be applicable to events and actions occurring on or after 90 days after the date these regulations are published in the Federal Register as final. Issuers may choose to apply the Proposed Regulations to events and actions occurring prior to such date.

#### **IV. Observations**

At least two provisions in the 2008 Notice appear to have been omitted from the Proposed Regulations.

The first is the provision that allows QTOBs to be remarketed at a fixed rate to maturity at a price other than par (plus accrued interest, if any). The 2008 Notice recognized that a certain amount of flexibility is appropriate in the context of pricing fixed-rate remarketings of tax-exempt bonds to maturity to give effect to actual market conditions, e.g., premium or discount pricing. The 2008 Notice allowed any premium to be treated as additional sale proceeds for arbitrage purposes.

The second provision concerns the eligibility of conduit issuers for a conduit loan yield 1.5 percent in excess of the bond yield that is permitted for “program obligations”. The definition of “program obligation” includes a prohibition against a conduit borrower’s ability to purchase tax-exempt bonds for a governmental program in an amount “related” to the amount of its purpose investment financed by the program. See, section 1.148-1(b) of the Treasury Regulations. Certain conduit borrowers (e.g., highly-rated 501(c)(3) borrowers), are able to (and will) acquire and hold a QTOB on which they are obligated to make the debt service payments, without resorting to third-party credit or liquidity support. While the acquisition of a tax-exempt bond by a conduit borrower will not cause such bond to be treated as retired, such acquisition would result in the issue failing to comply with definition of “program obligation” and the issuer losing its ability to claim the 1.5 percent spread on the purpose obligation. The 2008 Notice addressed this concern by providing 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 so ‘related’” for purposes of complying with the definition of program obligation.

It is expected that the foregoing will be reflected in comments to the Proposed Regulations.

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Please contact a member of the Hawkins Delafield & Wood LLP tax department with any questions.

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## Practice

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