The Essentials

Refunding & Reissuance (Real World Examples)

Tax Law Definition of “Refunding”

From Treas. Reg. 1.150-1(d):

Proceeds of “refunding” issue are used:

(1) to pay *interest, principal*, or *redemption premium*

(2) on “prior” issue of the *same* or *related obligor*

Tax Implications of Refunding vs. New Money Determination

- New Money issue may need to satisfy volume cap, "TEFRA" hearing, and other tax law requirements that would not apply to a refunding issue
- Refunding issue, if treated as *advance* refunding, is not permitted on a tax-exempt basis after 2017
- Form 8038 (8038G) requires the issuer to state whether the issue is a refunding

Is it a refunding?

Hypo #1:

- **County issues governmental bonds (the "Series A Bonds") to finance various projects. A portion of the proceeds will pay interest on the bonds during construction. Is it a refunding?**

Remember general rule: Proceeds of a refunding bond are used to pay interest, principal, or redemption premium on a prior issue of the same or related obligor

Is it a refunding?

Hypo #1 continued:

- What if the County decides to use a portion of the Series A Bond proceeds to pay interest on an earlier bond issue? Is it a refunding?
- What if the County issues a new series of bonds a year later and wants to use Series A Bond proceeds to make the initial interest payments on the new bond issue? Is it a refunding? If so, is it an advance refunding?
- What if the County also wants to use Series A Bond proceeds to make the initial <u>principal</u> payments on the new bond issue? Same result?

Is it a refunding?

Certain limited payments of interest on refunded bonds are ignored:

- up to one year of interest
- capitalized interest
- certain *de minimis amounts* (Treas. Regs. 1.148-6(d)(3)(ii)(A))

"Prior" issue may be issued before, after or at same time as refunding issue.

Current and Advance Refundings

"Current Refunding" =

- Payoff of refunded bonds occurs not later than 90 days after issuance of the refunding bonds

"Advance Refunding" =

- Payoff of refunded bonds occurs more than 90 days after issuance of the refunding bonds
- Tax-exempt advance refundings prohibited after 2017

Is it a refunding?

Hypo #2:

- **County issues conduit bonds and lends the proceeds to 501(c)(3) Hospital; Hospital later refinances the original bonds with obligations issued by City. Is it a refunding?**

<ins>Is it the Same (or Related) Obligor</ins>? Remember, refunding issue must have *same obligor* as refunded issue (or related obligor):

- "obligor" of conduit financing is conduit borrower (not actual issuer)
- in non-conduit financing, "obligor" is actual issuer of bonds

Is it a refunding?

Hypo #2:

- Park district issues governmental bonds to construct park facilities; City later refinances the original bonds. What do you need to know to determine if it is a refunding?

Is it a refunding?

Hypo #3:

- County issues conduit bonds and lends the proceeds to Borrower A to finance hospital. Borrower A later sells the hospital to Borrower B, who assumes responsibility for the bonds. Three months later, the County refinances the conduit bonds for Borrower B. Is it a refunding? If not, what are the consequences?

Reissuance

- **Changes to the terms of a bond issue that are sufficiently significant to justify treating the modification as resulting in a "deemed" or "constructive" *taxable exchange* of "old" for "new" ("reissued") bonds**
  - Tested under the rules of IRC 1001 (taxable sales, exchanges and other dispositions that result in the recognition of gain or loss) and Treas. Reg. 1.1001-3 (modifications of debt instruments)
  - Variable rate "tender bonds" may also be tested under rules set forth in IRS Notice 2008-41 (or Notice 88-130)
- **Treated like a current refunding for most federal tax purposes**

Reissuance

Hypo #4

- City issued $15 million in bank qualified bonds in 2009 which were privately placed with the Bank.
- The interest rate on the bonds is 5.0000 % and the bonds are currently outstanding in the amount of $9 million.
- The City has encountered financial difficulties and has asked the Bank to reduce the interest rate on the bonds to 4.0000% and to forgive $2 million of principal, reducing the outstanding balance to $7 million.
- The Bank agrees.
- Are there any tax implications to this transaction for the City?

Testing for Reissuance Under §1.1001-3

From Treas. Reg. 1.1001-3:

Two-part test: An obligation is "reissued" if there is (1) a "modification" to its terms that is (2) "significant."

(1) "<u>Modification</u>": Any alteration to the legal rights or obligations of the issuer or holder of an obligation (whether by amendment of bond documents, conduct of the parties, or otherwise)

(2) "<u>Significant</u>" modifications include the following:

- **Yield: Change that exceeds *greater* of 0.25% or 5% of prior yield**
- **Deferral of payments by more than *lesser* of 5 years or 50% of original term (*e.g.*, 10-year maturity could be extended to 15 years, 20-year maturity to 25 years)**

Reissuance: Why it Matters

- Taxable exchange (bondholders may need to recognize taxable gain or loss)
- Arbitrage rebate must be calculated and paid (within 60 days) following deemed discharge of "old" obligation (change to new yield)
- New "TEFRA" hearing may be required
- More favorable tax treatment of original obligations may be lost (*e.g.*, re AMT, "bank-qualified" obligations, etc.) – change in law risk
- New 8038 or 8038-G form must be filed with IRS
- Swaps/hedges deemed terminated (but note 2016 Final Regulations)

Reissuance

Hypo #5

- **State agency issued $10 million in conduit bonds in 2010. The proceeds were loaned to Borrower and bonds were privately placed with the Bank.**
- **Without calling the State agency or bond counsel, the Borrower and the Bank agree to amend the loan documents to:**
  - Reduce the interest rate to reflect changes in the market
  - Waive certain prepayment rights of the Bank
  - Modify some financial covenants and reporting requirements
- **The State agency finds out about the changes and calls you. What else do you need to know? Are there any tax implications to this transaction?**
- **What if the amendments were made 6 months before you found out about them?**

Is there a significant modification?

"<u>Significant</u>" modifications include the following:

- **Yield: Change that exceeds *greater* of 0.25% or 5% of prior yield**
- **Deferral of payments by more than *lesser* of 5 years or 50% of original term (*e.g.*, 10-year maturity could be extended to 15 years, 20-year maturity to 25 years)**
- **Obligor: Change in obligor of a *recourse* obligation**
  - "Obligor" for this purpose means only the *actual issuer* (change in conduit borrowers does not produce a reissuance)
  - Tax-exempt bonds are treated as "recourse" (unless the bonds (i) finance a conduit loan and (ii) *both* the bonds *and* the conduit loan are non-recourse)
- **Security: Change in security *only* if it results in a significant change in "payment expectations"**

Reissuance

Hypo #6

- County issues bonds pursuant to a multimodal indenture. The bonds are initially issued at a weekly rate, but may be converted to a daily rate, monthly rate, or a fixed rate under the terms of the indenture.
- Do you need to worry about whether the weekly rate adjustments result in a reissuance?
- Two years after the bonds are issued, the County decides to change the mode to a fixed rate. Could this result in a reissuance?

Is it a modification?

General rule in Treas. Reg. 1.1001-3:

(1) "<u>Modification</u>": Any alteration to the legal rights or obligations of the issuer or holder of an obligation (whether by amendment of bond documents, conduct of the parties, or otherwise)

- Does not include modification that occurs *automatically* under the original terms of the obligation upon the happening of events outside the control of the parties (*e.g.*, resetting variable rate to track market rate)
- Does not include exercise of *unilateral* right by a party

Testing for Reissuance under Notice 2008-41: Definitions

- "Qualified Tender Bonds" ("QTBs"): (1) Bear interest at either a fixed rate or a periodically reset "qualified floating rate" or "eligible objective rate" (§1275-5); (2) Pay interest at least annually; (3) Have a maturity of not more than 40 years; and (4) Are subject to optional or mandatory tender provisions

- "Qualified Interest Rate Mode Change": a change between interest rate modes that is authorized under the terms of the bond when originally issued

- "Qualified Tender Right": includes *option* on the part of a bondholder to tender bond at specified times and *requirement* of bondholder to tender bonds for purchase upon occurrence of certain events

Testing for Reissuance under Notice 2008-41

- **General Rule: No Reissuance of a QTB if:**
  - Qualified Interest Mode Change; or
  - Exercise or Existence of Qualified Tender Right
- **Issuer may repurchase QTB without causing the bonds to be treated as retired, if the bonds are remarketed within 90 days**
  - No limit for bonds purchased by nongovernmental conduit borrowers, third party guarantors and liquidity providers
- **Other changes (and the determination of whether a particular modification is "significant") are tested under Treas. Reg. 1.1001-3**

Testing for Reissuance under Notice 88-130 Definitions

- **"Tender Right"-- similar to Qualified Tender Right under Notice 2008-41**
  - "Tender Bond" -- any bond subject to a Tender right all interest on which accrues at a tender rate and is due at periodic intervals of one year or less
  - "Tender Rate" **--** lowest rate necessary to market/remarket the bond at par (plus accrued interest)
- **"QTB"-- a bond with a maturity of not more than 35 years**
- **"Change"-- any change in the legal rights or remedies of a bondholder unless all of the elements of the alteration are entirely outside the control of the parties**
- **"Qualified Tender Change" -- a change in the period between tender dates that occurs pursuant to the original terms of the bond**
- **"Qualified Corrective Change"-- a change that does not materially alter the rights or remedies of a holder, and addresses unforeseen circumstances or unintended results**
- **"Qualified Tender Purchase" -- any purchase of a QTB pursuant to a tender right if (1) it occurs pursuant to bond documents, (2) the terms of the bond require that best efforts be used to remarket the bond; and (3) the bond is remarketed no later than 30 days after the date of purchase**

Testing for Reissuance under Notice 88-130

- **A QTB is not reissued as a result of :**
  - the existence of the tender right
  - a Qualified Tender Purchase
  - a Qualified Tender Change
  - a Qualified Corrective Change
- **Reissuance of QTB is caused by:**
  - Any change to bond terms in connection with a Qualified Tender Change increasing the period between tender dates *from a period not exceeding one year to a period exceeding one year or vice versa* (ie, the hair trigger)
  - A change other than a Qualified Tender Change, in the period between tender dates
  - A change to the bond terms which by itself triggers a reissuance under §1001
  - Acquisition of the bond by or on behalf of the issuer or a true obligor which is a governmental unit or an agency or instrumentality thereof

- Proposed Reissuance Regulations (Dec. 31, 2018). Treasury and the IRS proposed reissuance regulations applicable to tax-exempt bonds on December 31, 2018. These regulations are generally consistent with existing law and guidance applicable to tax-exempt bonds. The proposed regulations are available at 83 F.R. 67,701 (Dec. 31, 2018). A summary of the proposed regulations is available in the session outline.