The Essentials

Refunding & Reissuance (Basic)

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Overview

- Refundings/Reissuance in General
- Tax Rules Applicable to Refundings
- Tax Rules Applicable to Reissuance

Terms and Concepts

"Refunding" =

- Proceeds of a new bond issue used to pay debt service on a prior issue of the same (or related) obligor
- Opposite of "New Money" issue

"Reissuance" =

- Changes to terms of existing bond issue which are sufficiently significant as to amount, in substance, to the *replacement* of the original issue with a "new" issue
- Treated for tax purposes as a "deemed" or "constructive" refunding of the original bond issue

Don't confuse refunding and reissuance with:

"Reimbursement" =

- Use of *new money* bond proceeds to pay issuer back for expenditures made in anticipation of a bond issue

Reasons to Refund

- **Reduce interest expense if interest rate on new (refunding) bond issue is lower than interest rate on prior (refunded) bond issue**
  - Savings arise after redemption (call) of prior bond issue

- **Obtain cash-flow benefit from restructuring debt service to stretch out principal payments**

- **Eliminate restrictive covenants**
  - Similar benefits achieved through amendments of bond documents without the issuance of new debt can result in a “reissuance”
- **Roll over short-term debt at its maturity**

Mechanics of a Refunding

3.5% bonds issued to refund bonds bearing interest at 5%:

new (refunding) issue — **3.5%**

↓

escrow — **3.5%**

↓

prior (refunded) issue — **5%**

- Proceeds of refunding issue are either used directly to pay debt service on refunded issue, or are held in *escrow* pending such use.
- Creation of refunding escrow may *defease* refunded bonds for indenture and state law purposes. For tax purposes, however, refunded bonds remain outstanding until fully paid (discharged).
- As prior issue is discharged, any remaining proceeds of prior issue become "transferred proceeds" of refunding issue for tax purposes

Types of Refundings

- **Net Defeasance**
  - Proceeds of refunding bonds <u>and investment earnings</u> used to pay principal, interest and call premium on outstanding refunded bonds when due
- **Full Cash or Gross Defeasance**
  - Proceeds of refunding bonds used to pay principal, interest and call premium on outstanding refunded bonds when due <u>without regard to investment earnings</u>
- **Crossover Refunding**
  - Proceeds of refunding bonds in escrow used to pay <u>interest on refunding bonds</u> and <u>principal of refunded bonds</u> on retirement date of refunded bonds. Interest on refunded bonds paid from other sources

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*

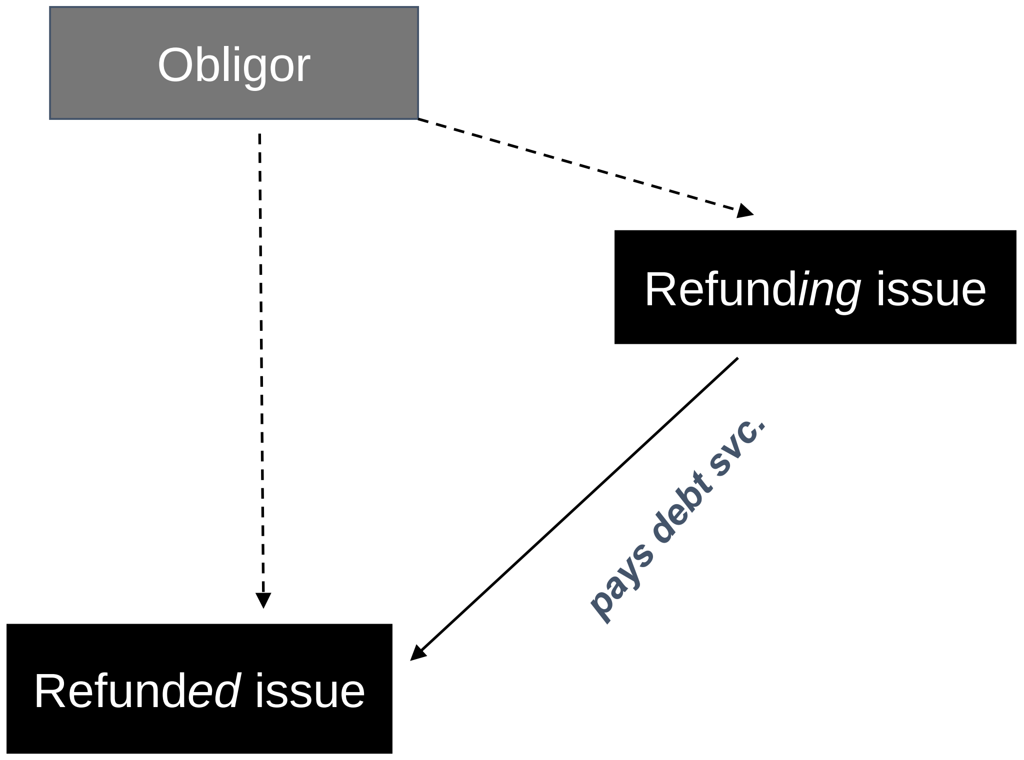
(1) Payment of Debt Service

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))

NOTE: “Prior” issue may be issued before, after or at same time as refunding issue.

Tax Law Definition of "Refunding"



(2) **<u>Same (or Related) Obligor</u>: 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

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 be permitted on a tax-exempt basis after 2017

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
- Cannot be done on a tax-exempt basis after 2017

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)

Watch for negotiations between parties in private placement

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)

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)

- 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 §1.1001-3

(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)**
- **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"**

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.