Refunding and Reissuance

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The Essentials

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Agenda

- Terms and Concepts
- Tax Rules Applicable to Refundings
- Tax Rules Applicable to Reissuances

Terms and Concepts

What is a Refunding?

- Proceeds of a new bond issue that are used to pay debt service on a prior issue of the same (or related) obligor
- The new issue is often called the "refunding issue" and the prior issue is often called the "refunded issue"
- Essentially a refinancing of existing debt
- If it's not a refunding then it's a new money issue

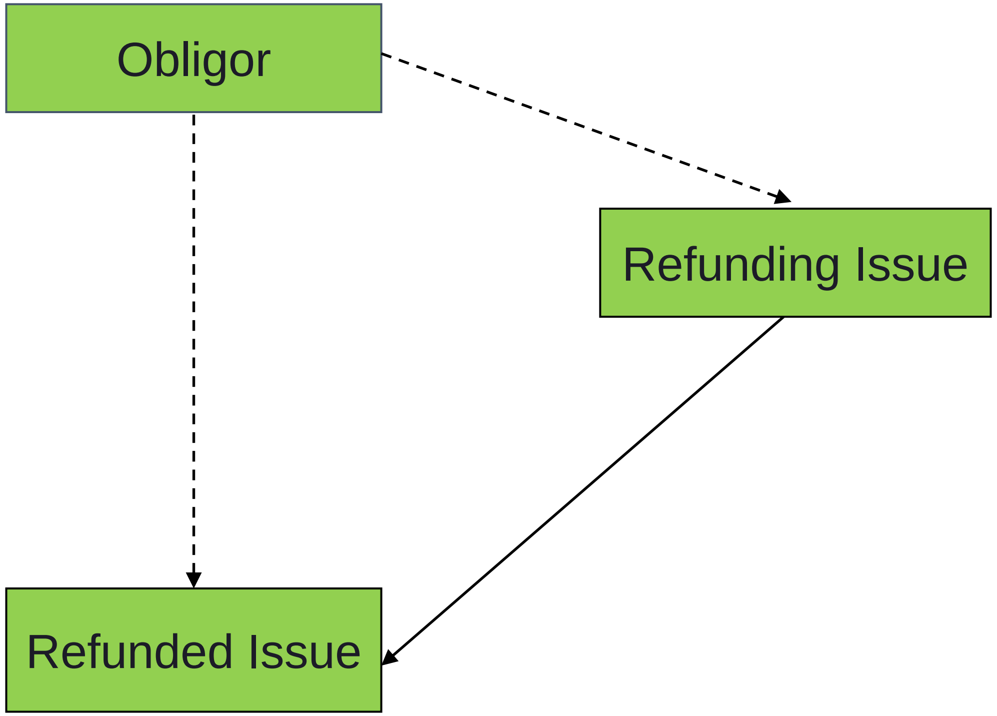
What is a Reissuance?

- One or more terms of an existing debt instrument are significantly changed such that the old debt instrument is treated as being replaced by the new, amended debt instrument
- Treated for tax purposes as a "deemed" refunding of the original debt instrument

Neither Are Reimbursements!

- Don't confuse the concepts of refundings and reissuances with reimbursements, which is the use of new money bond proceeds to pay issuer back for expenditures made in anticipation of a bond issue

Basic Mechanics of a Refunding



- Obligor issues new bonds (i.e., refunding issue)

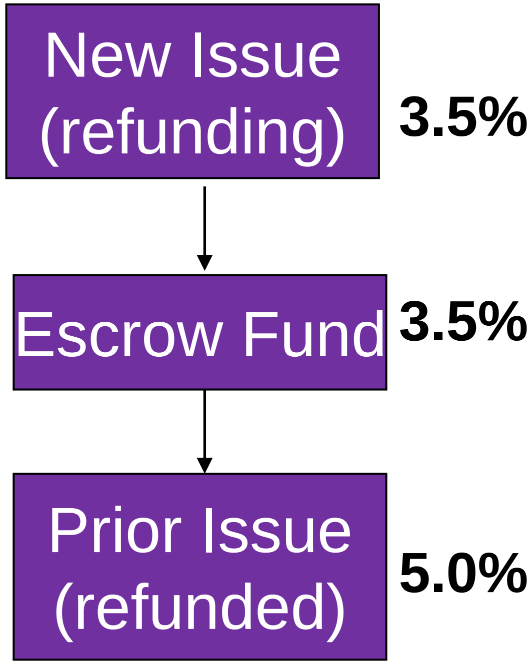
- Proceeds of refunding issue are either used immediately to pay debt service on refunded issue, or held in escrow pending subsequent payments of debt service

Reasons to Refund

Savings	• Refinance existing debt at a lower interest rate (“high-to-low refunding” or “in the money”) • This is the most common reason for refunding
Restructure Debt Service	• Usually by extending maturity dates (subject to state and/or tax limitations) or leveling out debt service to avoid peaks and valleys
Eliminate Restrictive Covenants	• Common in revenue bonds to remove outdated structures or to reflect current financial practices
Rollover short-term debt at its maturity	• Commercial paper; tax notes
Job Security for Public Finance Lawyers	• Just kidding!

Basic Mechanics of a Refunding

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



- Proceeds of refunding issue are held in escrow pending use to pay debt service on refunded bonds
- 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

Net Defeasance v. Cash Defeasance

Net Defeasance

- Proceeds of refunding bonds and investment earnings are used to pay principal, interest, and any call premium on refunded bonds when due
- Proceeds of refunding bonds are invested in SLGSs or government obligations purchased in the open market
- Typically requires the report of a verification agent as to mathematical accuracy and sufficiency to defease the refunded bonds

Full Cash (or Gross) Defeasance

- Proceeds of refunding bonds are used to pay principal, interest, and any call premium on refunded bonds when due without regard to investment earnings
- May have a verification report, although sometimes a "sufficiency certificate" from a financial advisor will be used instead

Tax Law Definition of "Refunding"

Treas. Reg. § 1.150-1(d)

- Refunding issue means an issue of obligations the proceeds of which are used to pay:
  - Principal'
  - Interest,* or
  - Redemption price on another issue (i.e., a "prior issue")

"Prior Issue"

- TRAP FOR THE UNWARY! A "prior issue" may be issued before, at the same time, or even after the refunding issue

Exceptions to Tax Law Definition

Certain Payments of Interest

Not a refunding if the only debt service paid with proceeds of the bond issue is:

- Interest that accrues on another issue during a one-year period including the issue date of the issue that finances the interest;
- Capitalized interest; or
- A working capital expenditure to which the de minimis rule of Treas. Reg. §1.148-6(d)(3)(ii)(A) applies

Issues with Different Obligors

Refunding issue must have same obligor as refunded issue (or related obligor)

- In a non-conduit financing (e.g., governmental bonds), the “obligor” is the actual issuer of the bonds
- In a conduit financing (e.g., an issue of qualified 501(c)(3) bonds), the conduit borrower is the “obligor”

Exceptions to Tax Law Definition

Acquisition Refinancing – The 6 Month Rule

- In general, if, within 6 months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an acquisition transaction, the assumed issue is refinanced, then it will be treated as a new money transaction
- More relevant for conduit financings; although initially raised to be a helpful rule for nonprofit health care systems, in other contexts it can be a serious trap for the unwary!

Why We Care About Refunding Determination

New Money Issues

New money issues are subject to certain tax law requirements that may not apply to refundings

- Ex: TEFRA approvals; volume cap; limitations on used property

Refunding Issues

- "Accidental" advance refundings
- Additional limitations on advance refundings (e.g., only allowed one), although less relevant after 2017

Current and Advance Refundings

These are tax law constructs that are very important to understand!

Current Refunding

- Redemption of refunded bonds occurs <u>not later than 90 days</u> after the issuance of the refunding bonds

Advance Refunding

- Redemption of refunding bonds occurs <u>more than 90 days</u> after issuance of the refunding bonds
- Tax-exempt bonds CANNOT advance refund a prior issue of tax-exempt bonds after 2017 BUT,
- Advance refundings are still allowed if the refunding bonds are taxable or if the refunded bonds are taxable if there is no double subsidy

Reissuance

General Concept

- Change(s) to a debt instrument that are sufficiently significant to justify treating the change as a "deemed" taxable exchange of "old" for "new" bonds; treated like a current refunding for most federal tax purposes

- Tested under IRC Section 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) and Prop. Treas. Reg. §§1.150-3 and 1.1001-3(a)(2)

Reissuance: Why It Matters

Potential federal tax consequences:

- Taxable exchange (bondholders may need to recognize taxable gain or loss)
- Arbitrage rebate must be calculated and paid 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., non-AMT, “bank-qualified” obligation) – change in law risk
- New IRS Form 8038 or 8038-G must be filed
- New calculation of “issue price”

Treas. Reg. §1.1001-3

- Two Part Test
  - Is there a “modification?”
  - If there is a modification, is it “significant”?

Remember – If there isn’t a “modification,” then there can’t be a reissuance even if the change otherwise looks significant! This is a tricky area of tax law (aren’t they all), so always go back to review Treas. Reg. §1.1001-3 and related guidance.

“Modification” Defined

General Rule

- A “modification” is any alteration (i.e., change), including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or the holder of a debt instrument
- Does not have to be an express agreement (oral or written); conduct of parties can result in a modification
- Can result from direct issuer-holder negotiations, but also from alterations that the issuer and holder accomplish indirectly through transactions with third parties

Exception to Definition of Modification

- Automatic alterations under original terms of instrument
- Unilateral Options
- Issuer's Failure to Perform
- Holder's Temporary Forbearance
- Failure to Exercise an Option

“Significant” Defined

General Rule

If, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered or economically significant (not super helpful)

Specific Rules - Significant modifications include:

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)

“Significant” Defined

Specific Rules (Cont’d)

- **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” (i.e., speculative to adequate or vice versa)

- **Accounting or Financial Covenants:** Not significant if change merely adds, deletes, or alters customary accounting or financial covenants

Bond Subject to a Tender Right

Notice 88-130, Notice 2008-41 (as amended), Proposed Treasury Regulations

IRS guidance for when bonds subject to a tender right, such as variable rate demand bonds, will be deemed reissued for federal tax purposes

Issuers can continue to rely on either Notice, although the Notice 2008-41 rules are more favorable (assuming no reissuance is desired)

Proposed Treasury Regulations released in 2018 generally following existing principles from Notices 88-130 and 2008-41, with certain adjustments (summary is available in the session outline)

Testing for Reissuance under Notice 2008-41

Testing for Reissuance under Notice 2008-41

“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 (bonds must be purchased and resold at par upon conversion, except if they are fixed to maturity)

“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

LIBOR Treasury Regulations

London interbank offered rate (“LIBOR”) is phasing out completely by June 30, 2023

Address concern that replacement of LIBOR could cause a reissuance

A modification that is a “covered modification” is not treated as the exchange of property for other property differing materially in kind or extent

LIBOR Treasury Regulations

Covered Modification

- The terms of the contract are modified to replace an operative rate that references a discontinued IBOR with **a qualified rate**, to add an obligation for one party to make a qualified one-time payment (if any), and to make associated alterations (if any).

- The terms of the contract are modified to include a qualified rate as a fallback to an operative rate that references a discontinued IBOR and to make an associated modifications (if any).

- The terms of the contract are modified to replace a fallback rate that references a discontinued IBOR with a qualified rate and to make associated modifications (if any).

- Any modification of the terms of a contract described in section 4.02 of Rev. Proc. 2020-44 (or subsequent guidance) is also treated as a covered modification

LIBOR Treasury Regulations

Qualified Rate

- Any of the rates described in Treas. Reg. § 1.1001-6(h)(3)(ii), provided such rate and the discontinued IBOR are based on transactions conducted in the same currency or are otherwise reasonably expected to measure contemporaneous variations in the cost of newly borrowed funds in the same currency

Associated Modifications

- A modification of the technical, administrative, or operational terms of a contract that is reasonably necessary to adopt or to implement the qualified rate

Excluded Modifications

- Various modifications that are not covered modifications, which therefore have to be tested under the general rules for reissuance

Questions