Refunding and Reissuance
Real World Examples

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Reasons to Refund

Hypo #1:
County issued its Series 2012 Bonds with a true interest cost of 4.5%. Under current market conditions, County can issue its Series 2023 Bonds with a true interest cost of 4.0%, resulting in an overall debt service savings of millions for the County. Should County do it?

Reasons to Refund

Hypo #2:
Acme Co. borrowed proceeds of Conduit Issuer's Series 2015 Revenue Bonds to finance the portion of Acme's manufacturing plant that qualifies as a "sewage facility" under the tax rules. In 2015, Acme was a new company with no real creditworthiness. As such, the bond documents required a large portion of Acme's revenues be deposited into various restricted funds. It's 2023 and business is a booming! What might Acme consider doing? How might a 103% call premium factor into the decision?

Is it a Refunding?

Hypo #3:
County issues governmental bonds (the "Series A Bonds") to finance various capital projects. A portion of the proceeds of the Series A Bonds will pay interest on the Series A Bonds during construction. Is it a 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")

Is it a Refunding?

Hypo #3 Continued:

- What if County wants to use a portion of the Series A Bonds to pay itself back for site improvements previously paid from its general fund? Is it a refunding?
- What if the County decides to use a portion of the Series A Bond proceeds to pay interest (which is not capitalized interest) on an earlier bond issue? Is it a refunding?
- What if County decides to use a portion of the Series A Bonds to pay the initial interest payments (which are not payments of capitalized interest) on a series of bonds issued 13 months after the issue date of the Series A Bonds? Is it a refunding? If so, what kind?

- **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 <u>on another issue</u> (i.e., a "prior issue")

Is it a Refunding?

Hypo #4:
County issued its Series 2015 Taxable Bonds to finance a parking garage, a substantial portion of which would be leased to a private company. The private company went out of business before the garage was completed; as a result, the parking garage is used for County employees who work in a nearby building. The Series 2015 Taxable Bonds are not callable until 2024. Can County issue Series 2023 Tax-Exempt Bonds to advance refund the prior issue?

- **Advance Refunding**
  - Redemption of refunding bonds occurs more than 90 days after issuance of the refunding bonds
  - Tax-exempt bonds CANNOT advance refund a prior issue of tax-exempt bonds after 2017

Is it a Refunding?

Hypo #5:

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?

Hypo #6:

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?

- **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"

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- **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

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 tax-exempt advance refundings (e.g., only allowed one prior to 2017)
  - Tax-exempt bonds CANNOT advance refund a prior issue of tax-exempt bonds after 2017

Is it a Refunding?

Hypo #8:
County issued its $10 million Series 2013 Bonds to finance street improvements. The yield on the Series 2013 Bonds was 5%. Due to several hurricanes that slowed construction and the COVID-19 Pandemic, proceeds of the Series 2013 Bonds in the amount of $2 million remain on deposit in the project fund. County wants to issue Series 2023 Bonds to currently refund the Series 2012 Bonds. The yield on the Series 2023 Bonds is 3%. What effect does the refinancing have on the $2 million remaining on deposit in the project fund?

- **Transferred Proceeds**
  - As a prior issue is discharged, any remaining proceeds of prior issue become “transferred proceeds” of refunding issue for tax purposes

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 Treas. Reg. §1.1001-3(a)(2)

Reissuance: Why it Matters

Hypo #9:
County issued $15 million of bank qualified bonds in 2009 that were privately placed with Bank. Due to financial difficulties, County has convinced Bank to agree to amend the bonds in such a manner that results in a reissuance for tax purposes. Is that a problem?

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., AMT, "bank-qualified" obligation) – change in law risk
- New IRS Form 8038 or 8038-G must be filed
- New calculation of "issue price"

Is it a Reissuance?

Hypo #10:
State agency issued $10 million in conduit bonds in 2018. The proceeds were loaned to Acme and the bonds were privately placed with Bank. The Agency, Acme and the Bank agree to amend the bond documents to (i) reduce the interest rate, (ii) extend the maturity date, (iii) modify a call right, (iv) substitute collateral, and (v) modify some financial covenants and reporting requirements. What do you need to know to determine whether a reissuance has occurred?

Two Part Test

1. Is there a "modification?"
2. If there is a modification, is it "significant"?

Is it a Reissuance?

Modification – General Rule	Significance – General Rule
• Subject to one main exception, 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	• If, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered or <u>economically significant</u> (not super helpful)

Is it a Reissuance?

Significance – Specific Rules

- **Yield**: Change that exceeds <u>greater</u> of 0.25% or 5% of prior yield
- **Deferral of payments**: By more than <u>lesser</u> 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)
- **Security:** Change in security only if it results in a significant change in "payment expectations" (i.e., speculative to adequate)
- **Accounting or Financial Covenants:** Not significant if change merely adds, deletes, or alters customary accounting or financial covenants

Is it a Reissuance?

Hypo #11:
County hospital enters a tax-exempt loan with Bank in 2015. The Loan Agreement provides that, if the corporate tax rate is ever decreased, the interest rate on the loan is automatically adjusted to maintain Bank's after-tax investment. The corporate tax rate is reduced in 2017 and the interest rate increases. Is this a reissuance? What if Bank agrees to maintain the initial rate? What if the Loan Agreement gives Bank the option to increase the rate upon the change in corporate tax rate but Bank elects not to do so?

- **Automatic alterations under original terms of instrument**
  - Must occur upon the happening of events outside the control of the parties
- **Significance in connection with a change in yield**
  - **Yield**: Change that exceeds <u>greater</u> of 0.25% or 5% of prior yield
- **Failure to Exercise an Option**
  - Not a modification

Is it a Reissuance?

Hypo #12:
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?

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 Regulations

Hypo #13:
County issues variable rate bonds in 2015 that are privately placed with Bank. The interest rate is USD-LIBOR plus 3%. In anticipation of the phase out of LIBOR, County and Bank agree to substitute USD-LIBOR for SOFR. Does this cause a reissuance? What else might you need to know? What if the County is required to make a one-time payment to offset the change in value of the bonds that results from the replacement? What if Bank requires an increase in the rate spread to address a deterioration in the County's ratings?

Questions