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Refunding and Reissuance

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I. Introduction

A. Overview of key terms.

1. "Refunding" is the term generally used to describe a refinancing of outstanding municipal debt. Compare this to obligations that do not refinance outstanding debt, commonly referred to as "new money" obligations.

2. "Reissuance" (or a deemed refunding for tax purposes) occurs when changes made to the terms of an existing municipal obligation are so significant as to amount virtually to the issuance of a new obligation under federal tax principles with the modified issue treated as refunding the original obligation.

II. Refundings

A. What happens in a refunding?

1. ***General Concept.***

i. A refunding involves the issuance by a state or local governmental entity of new bonds, the proceeds of which are used to pay debt service (principal, interest, and / or call premium) on another issue of bonds (typically referred to as the "refunded bonds"). The refunded bonds may be redeemed or retired (fully paid and cancelled) at the time of the refunding or, alternatively, the refunding proceeds may be placed in a defeasance escrow to provide for the payment of the refunded bonds at a later time.

ii. To illustrate the concept of a defeasance escrow, most fixed rate tax-exempt bonds are sold with a "no-call period" (usually around ten years from the issue date) that prevents the issuer from redeeming bonds until the end of the no-call period. The no-call period typically results in a lower overall interest rate because the bondholders have certainty that they will have tax-exempt interest at least during such period. An issuer, however, may find it financially advantageous to issue refunding bonds prior to the date that the refunded bonds are callable. In such a case, proceeds of the refunding bonds may be placed into a defeasance escrow for the refunded bonds, and such escrowed amounts, together with earnings thereon, are used to pay debt service through the call or retirement date of the refunded bonds. Generally, bondholders of bonds that have been defeased will look to the funds and investments held in the escrow account instead of to the issuer and the original security payment.

iii. After 2017, tax-exempt bonds cannot be issued to "advance refund" a prior issue of tax-exempt bonds (advance refundings are described in detail below). As a result, long-term defeasance escrows funded with proceeds of tax-exempt bonds are less prevalent than in the past, although they are still available in certain situations (*e.g.,* a refunding of direct pay Build America Bonds).[1] Lower interest rate environments may also be conducive to the advance refunding of tax-exempt bonds with proceeds of taxable bonds, which is still permitted.

2. ***Defeasance.***

i. There is a distinction between a discharge <u>of the lien</u> of the bond documents (*e.g.,* resolution, indenture, or other document) upon defeasance versus a discharge <u>of the bonds</u> (lingo for "payment" of the bonds). For tax purposes, a defeased bond generally continues to be outstanding and subject to tax requirements (*e.g.,* rebate must be calculated and paid with respect to the refunded bonds) until it is fully and finally paid and redeemed.

ii. *Legal Defeasance*. A legal defeasance is a formal release by the bondholder or trustee of the lien of the bond documents (remember that the lien benefits the bondholder) on the pledged assets or revenues in exchange for the pledge of cash or securities (*i.e.,* the defeasance escrow) sufficient to repay the bond. The moneys that are used to fund the defeasance escrow do not need to be refunding bond proceeds. A legal defeasance is accomplished only through the procedures provided in the bond documents governing defeasance; in the absence of a defeasance provision, a bond cannot be legally defeased.

iii. *Economic Defeasance*. If the refunded bonds cannot be legally defeased or if the defeasance provisions have not been fully complied with, the refunded bonds may be defeased on an economic

[1] *See* Chief Counsel Advice Memorandum 201843009.

basis if sufficient securities or cash are deposited in an escrow account to retire the bonds. An economic defeasance does not, however, provide for the release of the security, which means the bondholders will still have a lien on the assets or revenues securing the bonds.

iv. For a defeasance, the issuer may need to hire bond counsel to render an opinion to assure that the refunding bonds or the refunded bonds, or both, comply with all applicable tax rules and continue to be tax-exempt bonds. In addition, the opinion may address whether conditions for legal defeasances set forth in the indenture or resolution have been met (e.g., the securities being purchased for the escrow meet the definition of "defeasance securities" in the indenture and all other conditions are met).

v. Often, an escrow cash flow must be verified (usually by a certified public accountant) as to mathematical accuracy and sufficiency to defease the refunded bonds – often through a Verification Report. The opinion of bond counsel in connection with the defeasance would be based on this verification. An example of an economic defeasance that does not qualify as a legal defeasance is where the bond documents require a defeasance escrow to be invested only in U.S. Treasury Obligations, but the issuer, instead, invests in corporate securities (*e.g.,* bank certificates of deposit).

vi. The type of escrow investment that must be acquired to fund the defeasance escrow depends on the defeasance requirements of the bond documents. Typically, bond documents will require the investment in direct U.S. government obligations or guaranties, Treasury STRIPS, SLGS (State and Local Government Series) or U.S. Governmental Obligations (Treasuries). If the period during which the escrow is maintained is short, the bond documents may permit the defeasance moneys to be kept uninvested.

B. Why Engage in a Refunding?

1. ***To achieve debt service or interest cost savings when rates drop.*** In a "high-to-low refunding" (referring to interest rate), the issuer exercises an in-the-money call right on a callable prior issue before the issue's stated maturity date. The higher the coupon on the prior issue as compared to the current market yields, the greater the interest savings. Many issuers have established prerequisites (e.g., in the form of a debt management policy) of absolute dollar amounts of interest rate savings, a required percentage level of savings (expressed as a percentage of refunded or refunding bonds), or both, to undertake a refunding.

2. ***To restructure cash flow to obtain benefits.*** During recessionary periods, many issuers undertake refundings to defer existing debt service, particularly within the current or immediately succeeding fiscal year, which has the effect of freeing up existing cash flow for other purposes (sometimes referred to as "scoop and toss" or "restructure refunding").

3. ***To eliminate restrictive covenants in bond documents.*** This type of refunding generally is limited to revenue bonds because general obligation bonds usually have few, if any, meaningful covenants imposed upon an issuer other than the obligation to pay the bonds. The bonds to be refunded tend to be older bonds or bonds issued under older parity bond documents, because the bond covenants sought to be removed reflect outdated covenant structures that do not reflect modern financial practices. For example, if outstanding debt of an issuer is secured by a first lien on certain assets or revenue source, but the issuer wishes to issue additional debt secured by those same assets or revenues, this can be achieved by simultaneously issuing the additional debt and a refunding that defeases the outstanding debt.

4. ***To roll over short-term debt at its maturity.*** For various market and state-law reasons, an issuer may choose to issue debt (*e.g.,* one-year notes or commercial paper) that has a term that is shorter than the period over which the issuer decides to finance the expenditures in question. The concept of a refunding includes subsequent obligations that are issued to pay off the prior debt at its maturity (and thereby extend the period of financing).

III. Types of Refunding.

A. Net Defeasance.

1. The net cash refunding defeasance is the most common type of refunding. The proceeds of refunding bonds are placed into an escrow and invested in order to combat negative arbitrage. The proceeds of the refunding bonds, together with earnings thereon, are sufficient to pay the principal of and interest and call premium, if any, on the outstanding prior issue when due and payable. Issuance plus administrative costs must be paid from refunding bond proceeds, from the escrow cash flow, or from separate funds of the issuer or borrower.

2. The issuer pays interest on and principal of the refunding bonds from a source other than the escrow (*e.g.,* revenues or other security source previously used to pay debt service on the prior issue).

3. The issuer purchases government obligations (usually Treasuries or sometimes federal agency obligations) in the open market or pursuant to a bidding procedure or SLGS, if available.

B. Full Cash or Gross Defeasance.

1. A full cash defeasance may also be referred to as a gross defeasance or gross refunding. A full cash defeasance typically is undertaken only if a defeasance of the refunded bonds is necessary and the prior bond documents or local law require an initial deposit to the escrow of the full amount of the principal of and interest and call premium, if any, on the prior bonds, disregarding any investment earnings that may be earned on the refunding escrow, or if the escrow period is relatively short or purchasing investments is not possible or inefficient.

2. Full cash defeasances are not used frequently anymore because complex investment and issuance rules limit the benefits of such a transaction, except as described in 3 below for current refundings. A full cash defeasance in connection with an advance refunding under post-November 1992 documents may require a ruling from the IRS if Treas. Reg. §1.148-10(c)(5) is to apply. Prior to the existence of Treas. Reg. §1.148-10, all gross refundings required rulings from the IRS. *See* Treas. Reg. §1.103-15(c). The prohibition on gross refundings is probably less relevant now that tax-exempt advance refundings are prohibited.

3. Full cash defeasances have also been used in recent years in connection with short-term escrows for current refundings in order to avoid the cost of acquiring verification reports or purchasing escrow securities relative to the prevailing low rates at which escrow funds may be invested.

IV. Tax Definition of Refunding

A. Definition of Refunding. Treas. Reg. §1.150-1(d) sets forth the definition of a refunding for all purposes of Sections 103 and 141 through 150 of the Internal Revenue Code of 1986 (the "Code"). A refunding issue is generally defined in Treas. Reg. §1.150-1(d) as an issue the proceeds of which are used to pay principal of or interest or redemption price on another issue (the "prior issue") having the same or related obligor. A "prior issue" may be issued before, at the same time as, or after a refunding issue. The prior issue may be a taxable or a tax-exempt issue.

B. Uses of Refunding Bond Proceeds. Refunding bond proceeds can be used to pay issuance costs for, accrued interest on, a limited amount of interest on the refunding issue, and to fund a reserve fund if properly allocable to the refunding issue.

C. Exceptions to General Definition of Refunding.

1. ***Certain Payments of Interest.*** The bond issue will not be a refunding bond issue if the only debt service paid with proceeds of the bond issue (determined without regard to multipurpose rules of Treas. Reg. §1.148-9(h)) is:

i. payment of interest that accrues on another bond issue within a year of the issuance of the source bonds;

ii. payment of capitalized interest alone; or

iii. payment of interest that falls within one of seven *de minimis* exceptions under the working capital expenditure rules set forth in Treas. Reg. §1.148-6(d)(3)(ii)(A).

2. ***Different Obligors.*** If the obligor on the new bond issue is unrelated to the obligor on the refunded bond issue, then the new issue is not a refunding, but is treated as an acquisition with "new money" obligations of the property that was financed with the original obligations. Example: County issues bonds to refinance prior obligations that were issued by unrelated City to finance a sewage plant. Result: Not a refunding. The transaction is treated as an acquisition by County of the sewage plant with "new money" bonds of County.

   i. *Definition of "obligor*." In non-conduit financings, the "obligor" is the issuer of the bonds. In conduit financings, the "obligor" generally is the conduit borrower (sometimes called the "true obligor") under the purpose investment (conduit loan), except in certain financings of program obligations such as student loan and qualified mortgage loan financings. Example: County issues conduit bonds and lends the proceeds to 501(c)(3) Hospital; 501(c)(3) Hospital later refinances the original bonds with obligations issued by City. Result: Transaction is a refunding because 501(c)(3) Hospital (the conduit borrower with respect to both issues of obligations) is viewed as the "obligor" under both issues.

   ii. *Related parties; controlled group*. As noted above, a bond issue will be treated as a refunding only if it pays certain debt service on the prior obligation of the same or a related obligor. The obligors of different bond issues will be regarded as "related" if (i) they are part of the same controlled group in the case of governmental or qualified 501(c)(3) bonds or (ii) in the case of other private activity bonds, they are parties described in Code §144(a)(3) (basically, a greater than 50% common ownership situation).

   Generally, a "controlled group" means a group of entities under common management. *See* Treas. Reg. §1.150-1(e). For purposes of this definition, control focuses on the possession of rights or powers over the appointment and removal of members of the governing body of an entity or its financial decisions.

Proposed Treasury Regulations address the situation in which the parties become related in the course of an acquisition, an issue raised primarily by mergers and acquisitions of hospital systems (where the objective is generally to avoid refunding treatment, because of the restriction on advance refunding or arbitrage restrictions). *See* Prop. Treas. Reg. §1.150-1(d)(2)(ii), 67 FR 17309 et seq. (April 10, 2002) (adding new rules re "affiliated" persons).

3. ***Conduit Refundings.*** In some pooled bond transactions, the proceeds of the bond issue (Issue A) are loaned to several conduit borrowers. If a conduit borrower uses proceeds of another issue to repay the loan made from Issue A (Issue B), Issue B is treated as (i) a refunding of the loan and (ii) a refunding of Issue A if the original (pooled) issuer reasonably expects to use the repayment amounts of the loan to pay debt service on the original bonds and not to recycle the repayment amounts (make a new conduit loan).

4. ***Certain Acquisitions.*** Certain transactions involving both the repayment of a prior bond issue and a transfer of interests in the assets securing such issue will be treated as a sale of the assets rather than as a refunding for federal tax purposes, although not necessarily for state law purposes.

   The "6-month rule." In general, if within six months before or after a person assumes (in connection with an asset acquisition) an existing obligation of an unrelated party, the assumed loan is refinanced, the refinancing will not be considered a refunding. Treas. Reg. §1.150-1(d)(2)(v). Example: If a housing project is sold to a new, unrelated owner and the new owner assumes the bond obligations, the parties will generally avoid making changes to the bond documents (that could constitute a "deemed refunding" under the reissuance rules) within six months of the transfer of ownership of the project, so as to avoid having the transaction treated as an acquisition of the project with "new money" bonds.

D. Consequences of Not Being a Refunding. If an issue does not satisfy the definition of a refunding or fits an exception to that definition (*e.g.,* a transaction treated as an acquisition under the "6-month" rule), it is a "new money" issue for federal tax purposes and must satisfy all the applicable tax requirements to establish its tax-exemption (*e.g.,* requiring private activity bond volume cap, meeting rehabilitation requirements or subjecting the project and proceeds to more stringent requirements than may have applied with respect to the prior bond issue).

E. Two Kinds of Refundings.

1. ***Current Refunding:*** A current refunding occurs when refunding bond proceeds are used to retire or call other bonds *within 90 days* after the date of issuance of the refunding bonds. In other words, refunding bonds are

issued no more than 90 days before the redemption or payment date for the bonds to be refunded.

2. ***Advance Refunding:*** An advance refunding occurs when refunding bond proceeds are used to retire or call other bonds *more than 90 days* after the date of issuance of the refunding bonds. In other words, refunding bonds are issued more than 90 days before the redemption or payment date for the bonds to be refunded. If any of the bonds of a refunded issue are called or retired more than 90 days after the date of issuance, the refunding becomes an advance refunding (*see* paragraph I below regarding limitations on the issuance of advance refunding bonds after 2017).

F. Transferred Proceeds. Transferred proceeds are unspent proceeds of a refunded issue that get allocated to the refunding issue as the refunding bond proceeds pay principal on the refunded bonds (rather than on the date of issuance of the refunding bonds, which may be different). Transferred proceeds can include unspent original bond proceeds included in project funds, as well as moneys in the debt service reserve fund for the refunded bonds, or, if the bonds being refunded were themselves refunding bonds, proceeds of the bonds on deposit in a defeasance escrow. It is important in a refunding to trace the chain of refunding back to the original issue that financed an asset. If there are any proceeds remaining unspent in the chain of refundings (*e.g.*, an advance refunding escrow funded with a prior issue of bonds that has not been spent), transferred proceeds will be created. Transferred proceeds can arise in both current and advance refundings. *See* Treas. Reg. §1.148-9(b) for the basic operating rules for transferred proceeds.

Things to watch for: An escrow fund established with the proceeds of the refunded bonds is the most obvious candidate for transferred proceeds. However, be careful about the possibility of cascading transferred proceeds - meaning proceeds that transfer through several generations of refundings. This can occur, for example, if refunded bonds effected a current refunding of a prior generation of refunding bonds, and the prior generation refunding bonds created an escrow for refunding purposes that still exists. That escrow probably transfers all the way up to the refunding bonds and must be taken into account for yield restriction purposes. In that example, the yield on the remaining escrow will have to be restricted to the yield on the refunding bonds as the proceeds transfer (as the refunding bonds pay the refunded bonds). That yield restriction is typically accomplished through the payment of a transferred proceeds penalty calculated at the time the bonds are priced or structured by the underwriter.

G. Rebate. *For a discussion of the basic rebate requirement – see the General Tax Outline*. Also note that final retirement of refunded bonds when no other bonds of the issue of which the refunded bonds are a part are outstanding triggers a final rebate computation and potential rebate payment *for the refunded bond issue. In a current refunding, the redemption will occur within 90 days of the refunding bonds closing date. For an advance refunding it will occur when the refunded bonds are* *finally paid from the escrow established at closing*. Generally, any rebate liability will be due within 60 days following the date the refunded bonds are discharged.

H. Basic Rules for Current Refundings.

1. Proceeds must be used to pay debt service on the prior issue within 90 days after the date of issuance of the refunding bonds.

2. Proceeds of the refunding bonds are entitled to a general temporary period of 90 days during which such proceeds may be invested without yield limitation (and are eligible for 6-month rebate exception).

3. As compared to advance refundings, there are relatively few limitations on current refundings. However, as a general rule, most of the requirements for tax-exemption that applied to the refunded bonds will apply to the refunding bonds.

I. Basic Rules for Advance Refundings. (Code §149(d); Treas. Reg. §1.148-9).

1. After 2017, tax-exempt bonds cannot be used to advance refund a prior issue of tax-exempt bonds.

2. Taxable bonds still may be issued to advance refund a prior issue of tax-exempt bonds. In addition, tax-exempt bonds may be issued to advance refund a prior issue of taxable bonds as long as the refunding issue is the only issue of tax-advantaged bonds outstanding at any given time (*i.e.,* there is no "double federal subsidy").

V. Alternatives to Advance Refundings. Following the repeal of tax-exempt advance refunding bonds, issuers may choose to use one of the below structures as an alternative. These alternative structures can raise a variety of tax issues. While these structures are still relevant, many issuers have chosen to simply advance refund tax-exempt bonds with an issue of taxable bonds due to the current low interest rate environment (note that, in some cases, using taxable bonds to advance refund a prior issue of tax-exempt bonds can implicate the "universal cap" rule and create replacement proceeds, a discussion of which is beyond the scope of this of this outline).

A. Forward Bond Sale. A forward bond sale is a transaction in which an underwriter or bank agrees today to purchase fixed rate current refunding bonds on the call date and the parties agree today on all of the terms of the bonds to be issued on such call date.

B. Forward Swap. Another derivative product is the forward interest rate swap in which the issuer currently contracts for an interest rate swap, from a floating rate to fixed rate, which does not take effect until the call date of the bonds to be refunded. On the call date, the issuer issues a floating rate current refunding issue and, simultaneously, the interest rate swap becomes effective, thereby synthetically converting the floating rate bonds to a fixed rate issue. The issuer has, in effect, locked in the fixed interest rate by negotiating and contracting for the swap in advance.

C. **Swaption.** In exchange for the issuer's receipt of an up-front payment, the issuer grants a counterparty the right (but not the obligation) to enter into a floating-to-fixed-rate swap on the call date. If the swaption is exercised, the issuer issues a floating rate current refunding issue on the call date, receives a floating rate under the swap, and pays the fixed rate under the swap. If the swaption is not exercised, the issuer keeps the premium and may refund the bonds at a later date. One difference between the swaption and a forward swap is that the interest-rate savings under a swaption are reflected in the up-front premium payment received by the issuer. In the case of a forward swap, the savings are represented in the lower locked-in future fixed rate on the swap.

D. **Option.** The issuer executes a call option. In exchange for an up-front payment, the issuer grants a purchaser the option to buy fixed rate bonds from the issuer on or after the call date of the bonds to be refunded. The new bonds, when and if issued, will be used to currently refund the prior issue. The amount of the up-front payment is a function of the interest rate fixed for the new issue of bonds and the length of the options.

E. **Call Waivers.** In a typical advance refunding, the issuer may capitalize the interest savings by selling additional bonds in the window created by the lower debt service on the refunding bonds. A similar economic result can be obtained by receiving an up-front payment from the existing bondholders in exchange for a waiver of the call feature. The bondholder should be willing to pay an amount equal to the difference between the current price of the bond priced to the call date and the current price of the bond priced to maturity. Under Treas. Reg. §1.1001-3, the call waiver may be considered a reissuance of the bonds.

F. **Convertible or "Cinderella" Bonds.** This structure involves issuing new bonds which are taxable until the call date of the bonds to be refunded (or to some date within 90 days of the call date), when the new bonds become tax-exempt (or are exchanged for or reissued as tax-exempt). State law may treat this as a continuation of the taxable bond. Federal tax law treats the taxable issue as being refunded by a new tax-exempt current refunding issue. Although the term "Cinderella Bond" is intended to refer to a taxable bond which converts to a tax-exempt bond at some future date, most practitioners structure the transactions either as an exchange of a taxable bond for a tax-exempt bond at the eligible future date, or a reissuance of the taxable bond as a tax-exempt bond (requiring a reissuance trigger under Treas. Reg. §1.1001-3).

G. **Tender Offers and Exchanges for Prior Bonds.** As an alternative to causing the defeasance of bonds that are not subject to call, the issuer may be able to request the voluntary tender or exchange of bonds by bondholders. For either, attention must be paid with respect to detailed securities laws. This process may be time consuming and may require negotiation with bondholders. Further, tender offers and exchanges must be analyzed to determine whether the transaction results in a reissuance for tax purposes under Treas. Reg. §1.1001-3.

VI. Reissuance ("Deemed" Refundings)

A. Introduction.

1. ***Recognition of Gain or Loss.*** In general, for all purposes, not limited to tax-exempt bonds, Code §1001 and the Treasury Regulations promulgated thereunder provide that gain or loss on the sale of property or on the exchange of property for other property *differing materially either in kind or extent* must be recognized. When changes are made to a debt obligation that are so material as to amount virtually to the issuance of a new obligation, an exchange is deemed to occur. Whenever an exchange is deemed to occur under Code §1001 with respect to a tax-exempt bond, a reissuance is deemed to have occurred and a new bond is considered to have been issued for purposes of Code §103.

2. ***Simultaneous Exchange.*** A reissuance is treated as a retirement of the existing bond and the simultaneous issuance of a new bond, the proceeds of which are used immediately to retire the existing bond. The reissued bond therefore generally is considered to be a current refunding issue for purposes of federal tax law, although under circumstances described in Treas. Reg. §1.150-1(d)(2)(ii) and (v), relating to certain issues with different obligors and asset acquisitions, the reissued bond may not be considered a refunding issue.

3. ***Why we care. (Sometimes we don't.)*** The occurrence of a reissuance may have one or more of the following federal tax consequences:

    i. Because a reissuance is, by definition, a taxable exchange under Code §1001, bondholders may need to recognize taxable gain or loss.

    ii. Upon the deemed discharge of the original bonds, arbitrage rebate on the bonds must be determined and paid to the United States under Code §148(f), generally within 60 days. (Absent the reissuance, it is possible that future negative arbitrage would have offset any rebatable arbitrage accrued as of the date of the reissuance.)

    iii. A new "TEFRA" hearing and public approval may be required with respect to the bonds under Code §147(f) (if the average maturity of the bonds is extended). (A new allocation of volume cap is not usually required. *See* Code §146(i).)

    iv. Certain more favorable, "grandfathered" treatment under prior law may be lost, particularly in the case of bonds issued prior to enactment of the Tax Reform Act of 1986 (*e.g.,* as regards the minimum tax and "bank-qualified" treatment of bonds under Code §§57 and 265(b)(3)).

v. A new IRS Form 8038 (or 8038-G) form must be filed for the "reissued" bonds under Code §149(e) that typically reflects a current refunding.

vi. The issue price and yield of the deemed new issue must be determined.

vii. Qualified hedges are deemed terminated in a refunding or reissuance, although Treasury Regulations released on July 18, 2016 allow for the continuation of a qualified hedge from the refunded bonds to the refunding bonds.

viii. Reasonable expectations for private business use at the time of reissuance need to be analyzed.

ix. Transferred proceeds.

4. ***Applicable Rules.*** In general, the determination as to whether particular modifications to the terms of an obligation constitute a "reissuance" (and thus, in most cases, a refunding) will be made under the rules set forth in Treas. Reg. §1.1001-3 discussed in the following section. However, certain variable rate "tender bonds," which employ structures commonly used for tax-exempt floating-rate obligations, may be instead governed, at least in part, by the rules set forth either in IRS Notices 88-130 or 2008-41 (as amended by Notice 2008-88), as discussed further below.

B. Treasury Regulations Governing Reissuances.

1. ***General Rule.*** The general rule of Treas. Reg. §1.1001-3 is that a modification to the terms of a debt instrument will result in a deemed exchange of the original instrument for a new instrument if the modification is significant. Thus, the Treasury Regulations provide for a two-step analysis: first, whether a *modification has occurred*; and second, whether the modification is *significant*. The Treasury Regulations also provide several special rules applicable only to tax-exempt obligations.

2. ***Definition of Modification.***

i. Subject to one main exception for certain alterations (or changes) that occur by operation of the terms of a debt instrument, Treas. Reg. §1.1001-3(c)(1)(i) generally defines "modification" broadly as any change or alteration in a legal right or obligation (including the addition or deletion of a right or obligation) of the issuer or holder of a debt instrument.

ii. A modification may be evidenced by amendment of the instrument, conduct of the parties or otherwise, and may be effected directly between a holder and issuer or indirectly through one or more transactions with third parties. A modification generally occurs at the time the parties agree upon the modification, not when the modification goes into effect.

iii. In general, the Treasury Regulations apply broadly to debt modifications, regardless of form. The Treasury Regulations focus mainly on issuer-holder transactions involving negotiations between issuers and holders to modify the terms of a debt instrument. Treas. Reg. §1.1001-3(a)(1) applies to a debt modification that an issuer and holder accomplish indirectly through one or more transactions with third parties, but it does not apply to exchanges of debt instruments between holders, or holder-holder transactions.

3. ***Exceptions to Definition of Modification.***

i. An alteration that occurs by operation of the original terms of the debt instrument, either automatically or by the unilateral exercise of an option by the issuer or holder, is not a modification.

ii. An alteration is automatic if it occurs on the happening of an event not within the control of the parties, such as resetting the interest rate on variable rate bonds to match the current market rate.

iii. The exercise of a right is unilateral only if:

a. it does not create a right in the other party to alter or terminate the debt instrument or to put the debt instrument to a person who is related to the issuer (exception provided for tender option bond as set forth in Notice 88-130),

b. it does not require the consent of the other party or a person related to the other party, or the consent of a court or arbitrator, and

c. it does not require consideration, unless the amount thereof is *de minimis*, is fixed on the issue date, or is based on a formula that uses objective financial information.

iv. An obligor's failure to perform its obligations under a debt instrument is not itself a modification.

v. Absent a written or oral agreement to alter any other terms of a debt instrument, a holder's agreement to stay collection or to waive enforcing an acceleration or similar default right is not a modification, provided that the period of such forbearance does not exceed two years, plus such additional period during which the parties are conducting good faith negotiations or during which the issuer is involved in bankruptcy proceedings.

4. ***Changes that Are Always Modifications.***

i. Treas. Reg. §1.1001-3(c)(2) provides that a change that results in the substitution of a new obligor on a recourse obligation, the addition or deletion of a co-obligor resulting in a change in payment expectation, or a change in the recourse or nonrecourse nature of an instrument is always a modification, even if it occurs by operation of the original terms of the debt instrument.

ii. A change that results in a debt instrument or property right that is not debt for federal income tax purposes is always a modification.

iii. The exercise of an option to reduce the amount, or to defer the payment, of scheduled principal or interest is always a modification, even if the exercise would be considered unilateral under the rules described above.

5. ***Definition of Significant Modification.***

i. To the extent not covered by a specific rule described below, a modification is significant if, based on all the facts and circumstances, the legal rights and obligations being altered and the degree to which they are being altered are economically significant. All such modifications not subject to a specific rule are considered collectively in making this determination.

ii. The following special rules apply for determining whether certain modifications are treated as significant under the Treasury Regulations:

a. *Change in Yield*. Treas. Reg. §1.1001-3(e)(2) provides that a change in the yield on the debt instrument is significant if the change exceeds the greater of (A) 25 basis points, or (B) 5 percent of the annual yield of the unmodified debt instrument. In the case of a variable rate instrument, this test is applied by treating the yield on the instrument as being the yield on an equivalent fixed rate debt instrument.

b. *Deferral of Payments*. Treas. Reg. §1.1001-3(e)(3)(i) provides that a change in the timing and/or amounts of payments is significant if the change results in a material deferral of payments due under the debt instrument, taking into account all of the facts and circumstances. The Treasury Regulations further provide that a deferral of payments will not be treated as significant if it does not exceed a *safe-harbor period* beginning on the original due date of the first scheduled payment that is deferred and extends for the shorter of (A) 5 years, or (B) 50 percent of the original term of the instrument, taking into consideration any prior deferrals.

c. *Change in Obligor*. Treas. Reg. §1.1001-3(e)(4) provides that a change in the obligor of a *nonrecourse* debt instrument is not significant. (As noted below, however, most tax-exempt bonds are characterized as "recourse" obligations under these rules.)

A change in obligor on a recourse obligation is significant, except (A) such a change resulting from a transaction to which Code §381(a) applies (*i.e.,* an acquisition of substantially all of the assets of the old obligor) if the new obligor is the acquiring corporation, or (B) in the case of tax-exempt bonds, the new obligor is related to the original obligor and the collateral continues to include the original collateral.

The addition or deletion of a co-obligor is significant if it results in a change in payment expectations (*i.e.,* results in either a substantial enhancement or a substantial impairment of the obligors' capacity to meet the payment obligations under the debt instrument). *See* Notice 2008-41.

In the case of a tax-exempt bond, the term "obligor" in this context refers only to the actual issuer of the bonds and not to any conduit borrower. (Note that this definition of "obligor" differs from that used in the definition of a "refunding" under Treas. Reg. §1.150-1(d), discussed above, which treats the conduit borrower, rather than the governmental issuer, as the "obligor" of a conduit bond.) Example: City issues manufacturing bonds to finance a factory owned by Company A. Company A later sells the factory to unrelated Company B, which agrees to assume A's obligation to pay the outstanding bonds. Result: Since the "obligor" here is only the actual issuer – the City – the substitution of Company B for Company A as conduit borrower does not result in a "change in obligor." There is no reissuance. However, *see* "Change in Security" below.

d. *Change in Security*. Treas. Reg. §1.1001-3(e)(4) provides that a modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse obligation is significant. Such modification with respect to a recourse obligation is significant only if it results in a "change in payment expectations." (As noted below, most tax-exempt bonds are characterized as "recourse.") A substitution of collateral is not significant if the collateral is fungible or if it involves the substitution of a similar commercially available credit enhancement contract. Under Notice 2008-41, a change in collateral or security will trigger a reissuance for either a recourse or a non-recourse debt only if it results in a change in payment expectation.

If a change in security is not significant, there is no need to examine the change in security's effect on bond yield under the yield tests. Notice 2008-41, §3.1 and §7, Example (1).

e. *Change in priority*. Treas. Reg. §1.1001-3(e)(4)(v) provides that a change in the priority of a debt instrument relative to other debt of the issuer is significant if it results in a change in payment expectations. Thus, it is possible to change a debt instrument from senior to subordinated, or vice versa, without triggering a reissuance.

f. *Change in Recourse Nature of Debt Instrument*. Treas. Reg. §1.1001-3(e)(5)(ii) provides that a change in the nature of a debt instrument from recourse to nonrecourse, or vice versa, is significant, with the following two exceptions: (A) a defeasance of a "tax-exempt bond" by operation of the terms of the original bond; and (B) a change from recourse to nonrecourse where the instrument continues to be secured only by the original collateral (disregarding substitutions of fungible collateral) and there is no change in payment expectations.

Note the following three considerations in connection with the exception described in (A) above:

I. A tax-exempt bond is treated as recourse debt unless (x) it finances a conduit loan and both the bond and the conduit loan are nonrecourse debt instruments, or (y) it has been defeased with government securities. As a result, tax-exempt bonds will almost always be treated as "recourse" obligations under these rules.

II. In FSA 200035020 (Field Service Advice), the IRS concluded that the defeasance of tax-exempt bonds with amounts realized from the sale of property at an inflated price *did* result in a change in payment expectations and was a reissuance.

III. In AM 2014-009 (Advice Memorandum), the IRS determined that Build America Bonds are not "tax-exempt bonds" for purposes of the exception in (A). The defeasance of Build America Bonds may, therefore, lead to a reissuance of the bonds.

g. *Changes in Debt Status*. A modification that results in a property right that is not debt (*e.g.,* equity) for federal income tax purposes is significant.

h. *Changes in Financial Covenants*. Treas. Reg. §1.1001-3(e)(6) provides that a modification that adds, deletes, or alters customary accounting or financial covenants is not significant.

6. ***General Rules.***

i. Treas. Reg. §1.1001-3(f) provides certain rules of application for testing the significance of modifications. A modification generally is tested as to whether it is significant at the time the parties agree to it, even if it is not immediately effective. However, where a modification is subject to certain closing conditions requiring the approval of a third party, the modification is not taken into account until such approval has been obtained.

ii. Multiple modifications to different terms of a debt instrument (as contrasted with a series of modifications of the same term of a debt instrument over time) of the type described in 5.ii. above, none of which individually would constitute a significant modification, do not collectively constitute a significant modification.

iii. Multiple changes of the same kind over any period of time must be aggregated to test their significance and will constitute a significant modification if, had they been done as a single modification, the changes would have constituted a significant modification. A special exception exists for purposes of testing whether a particular modification causes a significant change in yield, by allowing an issuer to disregard any prior yield change that occurred more than five years before the modification being tested.

VII. Notices 88-130, 2008-27, 2008-41, and 2008-88 – Special Reissuance Rules for Certain Tender Bonds

A. Background. Pending the eventual issuance of regulations, Treasury and the IRS have issued several notices providing interim guidance for determining when bonds subject to a tender right, such as Variable Rate Demand Bonds (VRDBs) and certain Auction Rate Securities (ARSs), will be deemed reissued for federal tax purposes.

1. **Notice 88-130**, 1988-2 C.B. 543, provides generally that obligations satisfying the definition of "qualified tender bonds" set forth in the Notice will not be treated as reissued merely because of the existence or application of tender rights, because of a change between interest-rate modes provided for under the applicable bond documents, or upon the occurrence of certain other changes implemented pursuant to the terms of the initial bond documents.

    i. Notice 88-130 pre-dated Treas. Reg. §1.1001-3, which was promulgated in 1996 (following the publication of Proposed Regulations in 1992). The principal drafter of Notice 88-130 provided a useful explanation of the Notice's background and operation in Margaret C. Henry, Reissuance Revisited, 42 TAX NOTES at 100-105 (January 2, 1989).

    ii. Notice 88-130 provided comfort with respect to two particular areas of uncertainty: (i) that the typical tender and (temporary) repurchase feature of tender bonds would not result in a reissuance and (ii) that changes to the terms of bonds occurring "automatically" under the original bond terms (*e.g.*, upon a conversion from one interest rate mode to another) were not "changes" that would generally result in a reissuance.

    iii. When adopted in 1996, Treas. Reg. §1.1001-3 left the Notice 88-130 rules intact and expressly provided that such regulations "[do] not apply for purposes of determining whether tax-exempt bonds that are *qualified tender bonds* [as defined in Notice 88-130] are reissued for purposes of sections 103 and 141 through 150." Treas. Reg. §1.1001-3(a)(2) (emphasis added). The *Explanation of Provisions* accompanying the publication of the Treasury Regulations noted that "Notice 88-130 . . ., which provides special rules for qualified tender bonds, will continue to apply" to those obligations in lieu of the Treasury Regulations. 61 FR 32930 (June 26, 1996). However, most counsel interpret this to mean that certain aspects of Treas. Reg. §1.1001-3 will provide guidance as to whether changes to a tender option bond trigger a reissuance.

    iv. Notice 88-130 did not address auction-rate securities. As a result, there was some uncertainty whether auction rate securities were within the definition of "qualified tender bonds" subject to the Notice.

v. A summary of the rules set forth in Notice 88-130 is provided further below in Part VII.C of this outline.

2. **Notice 2008-27**, 2008-10 I.R.B. 543 (March 10, 2008). On February 19, 2008, Treasury and the IRS released Notice 2008-27 in order to "modif[y] certain special reissuance standards for 'qualified tender bonds' under IRS Notice 88-130." Notice 2008-27 was primarily issued in response to rating agency downgrades of municipal bond insurers and disruptions in the auction-rate bond markets. These developments had increased the need for guidance as to whether auction-rate securities were "qualified tender bonds" and as to the reissuance consequences of various transactions, such as converting from an auction-rate mode to another interest-rate mode, or replacing bond insurance with another form of credit enhancement. Treasury and the IRS used the opportunity of responding to specific market developments to provide additional, more general guidance in the Notice as to the relationship between the "tender bond" rules and the reissuance rules of Treas. Reg. §1.1001-3. This Notice is superseded by Notice 2008-41.

3. **Notice 2008-41**, 2008-15 I.R.B. 742 (April 14, 2008). On March 25, 2008, Treasury and the IRS released Notice 2008-41 to clarify, amend, supplement, and supersede the guidance provided in Notice 2008-27. While Notice 2008-41 generally followed the approach taken in Notice 2008-27, the later notice addressed certain specific questions that had arisen under Notice 2008-27 and extended the period of certain temporary relief provisions (which under Notice 2008-27 were effective until July 1, 2008) until October 1, 2008.

   i. Issuers of tax-exempt bonds may rely on the rules of Notice 2008-41 with respect to any actions taken with respect to such bonds on or after November 1, 2007. Alternatively, issuers may continue to rely on the rules of Notice 88-130. [Notice §8] (In most instances, however, the Notice 2008-41 rules are more favorable, assuming the goal is to avoid a reissuance.)

   ii. Notice 2008-41 states that it applies solely for purposes of Code §103 and §§141 through 150. (A similar caveat was contained in Notices 88-130 and 2008-27).

4. **Notice 2008-88**, 2008-42, 42 I.R.B. 933 (October 1, 2008). Notice 2008-88 generally extended until December 31, 2009 certain temporary provisions of Notice 2008-41, which, under Notice 2008-41, would have expired on October 1, 2008. In addition, the later Notice expands the coverage of Notice 2008-41 to expressly cover issues of tax-exempt commercial paper. Notice 2008-88 is retroactively effective as of March 25, 2008 (the effective date of Notice 2008-41). Except as amended by Notice 2008-88, Notice 2008-41 remains in effect.

5. **Notice 2020-25**, 2020-22 I.R.B. 863 (May 4, 2020). Notice 2020-25 temporarily expanded the circumstances and time periods that a tax-exempt bond could be purchased by its governmental issuer. The notice provided issuers the ability to purchase their own bonds and if such purchase occurred in 2020, to hold such bonds for the entirety of the 2020 calendar and 180 days beyond the end of 2020 without the occurrence of an extinguishment or reissuance.

B. Notice 2008-41 – Summary of Provisions (as amended by Notice 2008-88)

1. ***Definitions*** [Notice §3.2]

   i. *A Qualified Tender Bond* is a tax-exempt bond that has all the following features:

      a. *Interest rate mechanism*. During the term of each interest-rate mode authorized under the bond documents, the bond bears interest at either a fixed interest rate or at a variable rate that constitutes either a "qualified floating rate" on a variable rate debt instrument for tax-exempt bonds under Treas. Reg. §1.1275-5(b) or an "eligible objective rate" under Treas. Reg. §1.1275-5(c)(5). Permitted rate-setting mechanisms that qualify as "qualified floating rates" include "mechanisms that reasonably can be expected to measure contemporaneous variations in the cost of newly-borrowed funds," such as references to the SIFMA and other interest-rate indexes, tender-option based rate-setting mechanisms, or the use of Dutch auction processes. Permitted "eligible objective rates" include certain inflation-indexed rates as well as "qualified inverse floating" rates.

      b. *Interest payable at least annually*. Interest on the bond is unconditionally payable at periodic intervals at least annually.

      c. *Maximum term*. The final maturity date of the bond is not later than the earlier of 40 years after the issuance date of the bond or "the latest date that is reasonably expected as of the issue date . . . to be necessary to carry out the governmental purpose of the bond (with the 120 percent weighted average economic life of financed facilities test under Section 147(b) being treated as a safe harbor for this purpose)."

         Cf. Notice 88-130 limited the maximum term of qualified tender bonds to 35 years.

d. *Tender Provisions*. The bond is subject to an optional tender right or mandatory tender requirement that allows or requires a bondholder to tender the bond for purchase in one or more prescribed circumstances under the terms of the bond.

ii. *A Qualified Interest Rate Mode Change* is a change in the interest-rate mode on a bond that is authorized under the original terms of the bond.

In order for a mode change to be "qualified," the terms of the bond must also require that the bond be resold at par upon a conversion to a new interest-rate mode (unless the conversion is to an interest rate that is fixed to maturity).

iii. *A Qualified Tender Right* is either an option or a requirement on the part of a bondholder to tender a bond for purchase at par (and any accrued interest) either at specified times (*e.g.,* an ongoing tender option in connection with the rate-setting process) or as a mandatory requirement upon the occurrence of certain events (*e.g.,* a conversion from one interest-rate mode to another) on one or more tender dates prior to maturity, which tender option or requirement is set forth in the original terms of the bond.

Where bonds are acquired by the issuer or its agent, the terms of a "qualified tender right" must require the issuer or its agent to use at least best efforts to remarket the bond upon a purchase pursuant to the tender right.

2. ***General Rules*** [Notice §3.1, §3.2(3b)(b)]

i. **Neither a "qualified interest rate mode change" nor a "qualified tender right" (or the exercise of such a right) will be treated as a "modification" under Treas. Reg. §1.1001-3.** (Recall that in order for a reissuance to occur under Treas. Reg. §1.1001-3, there must generally be a "modification" that is "significant.")

Because the interest-rate variance directly related to (and resulting from) a "qualified interest rate mode change" is not a "modification," that variance need not be tested under the (25 basis point) change-in-interest-rate rules of Treas. Reg. §1.1001-3(e)(2).

ii. **Bonds purchased by or on behalf of a governmental issuer pursuant to a qualified tender right are not treated as retired if remarketed within 90 days.** [Notice §3.2(3)(b), as modified by §3.2 of Notice 2008-88, as modified by Section 3 of Notice 2010-7] (Under general tax principles, debt is usually treated as extinguished when acquired by its issuer.)

The requirement to remarket within 90 days only applies to purchases by governmental issuers or their agents. Bonds purchased by third-party guarantors, third-party liquidity providers, or by nongovernmental conduit borrowers may be held by such parties for an unlimited holding period without triggering a retirement of the bonds when purchased pursuant to the exercise of a qualified tender right. [Notice §3.2(3)(b), last paragraph]

iii. **Go read the §1001 Regulations for everything else.** In circumstances not specifically addressed by Notice 2008-41 (as amended), the determination of whether tax-exempt bonds are reissued as a result of any modification to the bonds is to be made based on whether the modification in question is a "significant modification" under the rules of Treas. Reg. §1.1001-3.

It was not clear under Notice 88-130 whether, and when, qualified tender bonds were also subject to the provisions of the Treasury Regulations. In addition, there was concern that Notice 88-130 imposed a "hair-trigger" test for reissuances that could be met by minor modifications that would not be "significant" under the Treasury Regulations. Notice 2008-41 (as amended) expressly makes the Treasury Regulations the "default" rules for situations not covered by the Notice and makes clear that qualified tender bonds are not intended to be subject to "hair-trigger" reissuance standards that are more stringent than those generally set forth for other obligations in the Treasury Regulations.

3. ***Special Rules.*** Notice 2008-41 (as amended) also set forth several special rules that addressed particular questions arising under market disruptions.

i. *Modifications of Security or Credit Enhancement*. [Notice §6.1] Modifications to the security or credit enhancement on a tax-exempt bond are "significant" under Treas. Reg. §1.1001-3(e)(4)(iv)(B) only if the modifications result in a "change in payment expectations" under §1.1001-3(e)(4)(vi), whether the bonds are recourse or non-recourse obligations. A reissuance will result under this standard only if the obligor's capacity to meet its payment obligations go from "primarily speculative" to "adequate" or vice versa.

ii. *Modifications of Qualified Hedges.* [Notice §5.1] A modification of a swap or other qualified hedge will not result in a termination of the hedge if the modification is not reasonably expected to change the yield on the related bonds over their remaining term by more than 0.25% or 25 basis points and the yield on the bonds is adjusted to reflect the modifications to the hedge.

iii. *"Program Investment" Restrictions*. [Notice §5.2] Where bonds have been issued to finance "program investments," a conduit borrower's purchase of an auction-rate bond in order to facilitate liquidity under adverse market conditions will not be regarded as violating the provisions of Treas. Reg. §1.148-1(b), which restrict the ability of a conduit borrower to purchase bonds in an amount "related" to the amount of the conduit borrower's purpose investment that was financed by the program in question.

C. Notice 88-130. As was noted above, the reissuance rules of Notice 2008-41 for qualified tender bonds largely replace the rules that were set forth in Notice 88-130 and are generally more favorable (assuming the goal is to avoid the occurrence of a reissuance). However, when a reissuance is the desired outcome, it may be easier to achieve under Notice 88-130 than Notice 2008-41. Notice 2008-41 makes clear that issuers may still choose to rely on the rules of Notice 88-130. Accordingly, the following summary of those rules is provided:

1. ***Definitions***

i. *Subject to a Tender Right*. A bond is subject to a tender right if the holder may or must in all events tender the bond for purchase or redemption at par (plus accrued interest) pursuant to the terms of the bond on one or more tender dates before the final stated maturity date.

ii. *Tender Bond*. A tender bond is any bond that is subject to a tender right if all interest (other than in the event of a remote contingency) accrues at a tender rate and is due at periodic intervals of one year or less.

iii. *Tender Rate*. Interest on a bond that is subject to a tender right accrues at a tender rate if (i) with respect to interest to the first tender date, the interest rate is set on or after the sale date at the lowest rate necessary to market the bond at par (plus accrued interest) on the issue date; and (ii) with respect to interest between tender dates, under the terms of the bond the interest rate is reset for each period at the lowest rate necessary to remarket the bond at par (plus accrued interest) at the beginning of the period. Reasonable maximum and/or minimum rates are permissible if they are not designed to front-load or back-load interest.

iv. *Qualified Tender Bond*. A qualified tender bond is any tender bond with a final stated maturity date no later than the earlier of (i) 35 years after the issue date, and (ii) the latest date reasonably expected (as of the issue date) to be required to carry out the governmental purpose of the issue. Clause (ii) will be deemed to be met if the weighted average maturity of the issue does not exceed 120% of the average reasonably expected useful life of the facilities being financed.

v. *Change*. A change is any discretionary alteration in the legal rights or remedies of a holder of a bond that occurs after the issue date. An alteration to the terms of a bond is discretionary unless all of the elements of the alteration are entirely outside the control of the issuer, any true obligor (*e.g.,* borrower), any holder, any related person, anyone acting on behalf of any such person or any combination of the foregoing.

a. An alteration in the period between tender dates that occurs at the option of the issuer is a change.

b. Alterations that occur automatically as a result of other discretionary alterations are not changes.

c. The resetting of the interest rate to a tender rate from another tender rate pursuant to the terms of a bond is not a change.

d. The replacement of a credit enhancer with a credit enhancer with a different rating is a change, even if the documents permit such a replacement.

vi. *Qualified Tender Change*. A qualified tender change is a change in the period between tender dates (including the final period to maturity) that occurs pursuant to the original terms of the bond.

vii. *Qualified Corrective Change*. A qualified corrective change is any one of the following:

a. A change that does not materially alter the rights or remedies of a holder. Such changes do not include any changes in the final stated maturity date, the interest rate, the payment dates or the security.

b. A change that corrects the terms of the bond to eliminate a result that could not reasonably have been intended on the issue date.

c. A change that is necessary solely by reason of circumstances occurring after the issue date that:

I. could not have been reasonably anticipated on the issue date;

II. are not related to bond market conditions or the creditworthiness of the issue; and

III. are not within the control of the issuer, any true obligor, any holder, any related person, anyone acting on behalf of any such person or any combination of the foregoing.

viii. *Qualified Tender Purchase*. A qualified tender purchase is any purchase of a qualified tender bond pursuant to a tender right if:

a. such purchase occurs pursuant to the terms of the bond;

b. the terms of the bond require that best efforts be used to remarket the bond; and

c. the bond is remarketed no later than 30 days after the date of purchase.

2. ***General Rules.***

i. A qualified tender bond will be treated as retired (*i.e.,* reissued) only if:

a. in a transaction or series of transactions there is any change to the terms of the bond (other than a qualified corrective change) in connection with a qualified tender change, which qualified tender change increases the period between tender dates *from a period not exceeding one year to a period exceeding one year or vice versa* (*i.e.,* the hair trigger);

b. there is a change in the period between tender dates that is not a qualified tender change;

c. there is a change to the terms of the bond (other than a qualified corrective change) which would cause a disposition of the bond under Code §1001 without regard to the existence or exercise of the tender right;

d. the bond is purchased or otherwise acquired by or on behalf of the issuer or a true obligor which is a governmental unit or an agency or instrumentality thereof; or

e. the bond is otherwise retired or redeemed.

ii. A qualified tender bond will not be treated as retired merely by reason of

a. the existence of the tender right;

b. a qualified tender purchase;

c. a qualified tender change;

d. a qualified corrective change; or

e. any combination of the foregoing.

iii. A bond that is subject to a tender right, but is not a qualified tender bond, is treated as retired on the first day that:

a. there is a change to the terms of the bond that results in a disposition of the bond for purposes of Code §1001;

b. the bond is purchased or otherwise acquired by or on behalf of the issuer or a true obligor which is a governmental unit or an agency or instrumentality thereof; or

c. the bond is otherwise retired or redeemed.

iv. For purposes of 2.ii. and 2.iii. above, a bond will be treated as purchased or otherwise acquired by or on behalf of a person if the bond is purchased or otherwise acquired (other than pursuant to the terms of a third party guarantee) by that person (or by any other person in consideration of any payment provided directly or indirectly by such first person in a manner that liquidates the holder's investment).

v. Except for bonds originally sold on or before December 14, 1988, a bond that is subject to a tender right but is not a qualified tender bond will be treated as if purchased on each tender date pursuant to the tender right (regardless of whether the tender right is exercised).

vi. Any reissuance which occurs as a result of a change occurs on the date the terms of the bond are altered, even though the effect of that alteration may occur later (*e.g.,* the addition to the terms of a bond of a new tender and interest rate mode results in a reissuance on the date the terms of the bond are amended, even though the issuer does not elect at such time to convert the bonds to that mode).

D. Proposed 2018 Reissuance Regulations

1. ***Background***. On December 31, 2018, Treasury and the IRS released proposed reissuance regulations (the "Proposed 2018 Regulations") for tax-exempt bonds (83 F.R. 67,701 (Dec. 31, 2018)). The Proposed 2018 Regulations would make final certain principles from existing published guidance, primarily in Notices 88-130 and 2008-41, with certain adjustments.

2. ***Reissuance/Retirement in General***. Under the Proposed 2018 Regulations, tax-exempt bonds are considered retired when any of the following occur:

   i. A significant modification is made to the bond under Treas. Reg. §1.1001-3;

   ii. The issuer or its agent acquires the bond in a manner that liquidates or extinguishes the bondholder's investment in the bond; or

   iii. If the bond is otherwise redeemed (for example, at maturity or pursuant to an optional redemption).

3. ***Definition of "Issuer."*** The Proposed 2018 Regulations continue to define the term "issuer" as the actual issuer of the bonds (or a related party to the issuer), so that a borrower under a conduit loan that is not related to the actual issuer is not treated as the issuer.

4. ***Consequences for Retired Bonds***. Where a bond is retired pursuant to a deemed sale or exchange, the bond is simply treated as though it were paid off (this is a relatively rare circumstance). Where a bond is treated as "resold," as in the case of a deemed exchange that accompanies a modification to the terms of an outstanding bond, the modified bond is considered a new bond that is treated as refunding the unmodified bond.

5. ***Qualified Tender Bonds***. Qualified tender bonds are generally bonds (i) that bear interest pursuant to one or more interest rate modes that are pre-authorized under the governing documents and (ii) that grant the holders the right to tender their bonds upon certain events (usually a change in the interest rate mode and a periodic resetting of the interest rate). The Proposed 2018 Regulations define a qualified tender bond as a tax-exempt bond that bears interest at one more qualifying interest rates, bears interest that is unconditionally payable at periodic intervals of no more than one year, has a stated maturity date that is not longer than 40 years after the issue date, and includes a qualified tender right. A qualified tender right is the right or obligation of the holder of a bond to tender the bond for purchase to the issuer, its agent, or another party on at least one date before the stated maturity date of the bond at a purchase price of par plus accrued interest, and where following such tender the issuer or its remarketing agent either redeems the bond or uses its reasonable best efforts to resell the bond within the 90-day period beginning on the date of the tender. Upon such resale, the purchase price of the bond must be equal to par (plus any accrued interest).

6. ***Acquisition of Bonds by Guarantors/Liquidity Facility Providers***. As is true under existing law, the Proposed 2018 Regulations make clear that the acquisition of bonds by an unrelated third-party guarantors or liquidity providers do not result in a retirement of the bonds.

E. Reissuance Regulations Related to LIBOR Phase Out

1. ***Background***. Interbank offered rates are benchmark interest rates that are set based on the rates at which banks lend to and borrow from one another on the interbank market. The London interbank offered rate ("LIBOR") is the most widely used interbank offered rate. Many municipal bonds and other related financial projects (*e.g.,* swaps) use a LIBOR-based interest rate. For example, the interest rate on a variable rate bond may be set at LIBOR plus a specified number of basis points. In 2017, the U.K. regulator tasked with overseeing LIBOR announced that all currency and term variants of LIBOR, including U.S.-dollar LIBOR ("USD-LIBOR"), may be phased out over time – with a complete phase-out to be undertaken by June 2023. As a result, the municipal finance industry has been concerned that changes to debt obligations and related financial products necessary to address the phase out could cause an unexpected reissuance of the debt for federal tax purposes. In response to these concerns, on October 9, 2019, Treasury and the IRS released proposed regulations addressing, among other things, whether changes arising out of the end of LIBOR will result in a reissuance for federal tax purposes. *See* Prop. Treas. Reg. §1.1001-6. Treasury and the IRS subsequently issued Final Regulations under Treas. Reg. §1.1001-6 (the "Final LIBOR Regulations") that are effective for modifications that occur on or after March 7, 2022, but can be applied to modifications entered into prior to such date (as long as consistently applied).

2. ***General Rule.*** The Final LIBOR Regulations provide rules relating to the modification of the terms of a contract as part of the transition away from LIBOR and other interbank offered rates. In general, a modification of a debt instrument that is a "covered modification" is not treated as the exchange of property for other property differing materially in kind or extent for purposes of Treas. Reg. § 1.1001-1(a). Similar rules apply with respect to modifications related to qualified hedging transactions under Treas. Reg. § 1.148-4(h). To the extent the modification is a "noncovered modification," the general rules set forth under Treas. Reg. § 1.1001-1(a) and Treas. Reg. § 1.1001-3 apply. The Final LIBOR Regulations also includes several examples illustrating fact patterns that help provide context to the various definitions and rules.

3. ***Relevant Definitions: Treas. Reg. § 1.1001-6(h)***

   i. *Covered Transaction*: A modification is a "covered modification" if it meets one or more of the following (and is not otherwise excluded from the definition of covered modification, as described below):

      a. 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).

b. 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).

c. 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).

d. 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.

e. A modification of the terms of a contract includes any modification of the terms of the contract, regardless of the form of the modification (for example, a modification may be an exchange of one contract for another, an amendment to the existing contract, or a modification accomplished indirectly through one or more transactions with third parties) and regardless of whether the modification is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

ii. *Noncovered Modification*: A noncovered modification is any modification or portion of a modification of the terms of a contract that is not a covered modification.

iii. *Qualified Rate*: A qualified rate is 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.

iv. *Fallback Rates*: A single qualified rate may be comprised of one or more fallback rates (for example, a waterfall of fallback rates). More specifically, if the rate being tested as a qualified rate is comprised of more than one fallback rate, the rate is a qualified rate only if each individual fallback rate separately satisfies the requirements to be a qualified rate.

a. This rule treats a waterfall of fallbacks as a unit and evaluates that unit to determine if it is a qualified rate. Thus, if the waterfall is designed so that each tier replaces the preceding tier when triggered (for example, when USD LIBOR ceases, USD LIBOR is replaced by the first tier of the waterfall and, if the first tier of the waterfall ceases, that first tier is replaced by the second tier), the entire waterfall is treated as a fallback to a discontinued IBOR even though, as a technical matter, only the first tier of the waterfall is a fallback to the discontinued IBOR.

b. Except with respect to fallback rates that are remote, if it is not possible to determine at the time of the modification being tested as a covered modification whether a fallback rate satisfies the requirements of a qualified rate (for example, the calculation agent will determine the fallback rate at the time that the fallback rate is triggered based on factors that are not guaranteed to produce a rate listed in Treas. Reg. § 1.1001-6(h)(3)(ii)), the fallback rate is treated as not satisfying the requirements to be a qualified rate.

c. If the likelihood that any value will ever be determined under the contract by reference to a fallback rate is remote (determined at the time of the modification being tested as a covered modification), that fallback rate is treated as satisfying the requirements to be a qualified rate.

v. *Discontinued IBOR*: A discontinued IBOR is any interbank offered rate described in Treas. Reg. § 1.1001-6(h)(4)(i) or (ii) but only during the period beginning on the date of the announcement described in Treas. Reg. § 1.1001-6(h)(4)(i) or (ii) and ending on the date that is one year after the date on which the administrator of the interbank offered rate ceases to provide the interbank offered rate.

a. The stated purpose of this new definition is to tailor the relief provided in the Final LIBOR Regulations to better match the problem that the Final LIBOR Regulations are intended to address.

b. Because of the reference to "one year" appears to mean that the modification has to occur within one year of the expiration of the IBOR in order to fall within the general rule under the Final LIBOR Regulations.

vi. *Associated Modification*: An associated modification is a modification of the technical, administrative, or operational terms of a contract that is reasonably necessary to adopt or to implement the qualified rate. An associated modification also includes an incidental cash payment intended to compensate a counterparty for small valuation differences resulting from a modification of the administrative terms of a contract, such as the valuation differences resulting from a change in observation period.

a. An example includes a change to the definition of interest period or a change to the timing and frequency of determining rates and making payments of interest (e.g., delaying payment dates on a debt instrument by two days to allow sufficient time to compute and pay interest at a qualified rate computed in arrears).

b. The Treasury Department and the IRS caution, however, that a payment of an amount that is not incidental cannot qualify as an associated modification.

vii. *Qualified One-Time Payment*: A qualified one-time payment is a single cash payment that is intended to compensate the other party or parties for all or part of the basis difference between the discontinued IBOR and the interest rate benchmark to which the qualified rate refers.

viii. *Excluded Modifications*: The following are excluded from the definition of covered modifications (and are therefore noncovered modifications):

a. The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is intended to induce one or more parties to perform any act necessary to consent to a modification to the contract described in Treas. Reg. § 1.1001-6(h)(1)(i), (ii), or (iii).

b. The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is intended to compensate one or more parties for a modification to the contract not described in Treas. Reg. § 1.1001-6(h)(1)(i), (ii), or (iii).

c. The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is either a concession granted to a party to the contract because that party is experiencing financial difficulty or a concession secured by a party to the contract to account for the credit deterioration of another party to the contract.

d. The terms of the contract are modified to change the amount or timing of contractual cash flows and that change is intended to compensate one or more parties for a change in rights or obligations that are not derived from the contract being modified. If each contract in a given portfolio of contracts has the same parties, those parties modify more than one contract in the portfolio (each such contract is a modified portfolio contract), and those modifications provide for a single, aggregate qualified one-time payment with respect to all modified portfolio contracts, then the portion of the qualified one-time payment allocable to any one modified portfolio contract is treated for purposes of this paragraph as not intended to compensate for a change in rights or obligations derived from any other modified portfolio contract.

e. The terms of the contract are modified to change the amount or timing of contractual cash flows and the modification is identified for purposes of this paragraph (j)(5) in guidance published in the Internal Revenue Bulletin (see Treas. Reg. § 601.601(d)(2)(ii)(a)) as having a principal purpose of achieving a result that is unreasonable in light of the purpose of this section. From the Preamble on this point, the Treasury Department and the IRS reserve the authority to expand this list of excluded modifications in guidance published in the Internal Revenue Bulletin. To exercise this authority, the Treasury Department and the IRS must conclude that the modification to be described in such guidance has a principal purpose of achieving a result that is unreasonable in light of the purpose of Treas. Reg. § 1.1001-6. The Treasury Department and the IRS have concluded that this reservation of authority is necessary to prevent any unforeseen abuses of the significant flexibility granted to taxpayers in the Final Regulations. However, the Treasury Department and the IRS anticipate that any such guidance would be prospective in effect.

4. ***Contemporaneous Noncovered Modifications***

i. If a covered modification is made at the same time as a noncovered modification, Treas. Reg. § 1.1001-1(a) or Treas. Reg. § 1.1001-3, as appropriate, applies to determine whether the noncovered modification results in the exchange of property for other property differing materially in kind or in extent.

ii. In applying Treas. Reg. § 1.1001-1(a) or Treas. Reg. § 1.1001-3 for this purpose, the covered modification is treated as part of the terms of the contract prior to the noncovered modification. For example, if the parties to a debt instrument modify the interest rate in a manner that is a covered modification and contemporaneously extend the final maturity date of the debt instrument, which is a noncovered modification, only the extension of the final maturity date is analyzed under Treas. Reg. § 1.1001-3 and, for purposes of that analysis, the modified interest rate is treated as a term of the instrument prior to the extension of the final maturity date.

5. ***Integrated Transactions and Hedging Transactions***

i. In general, a covered modification of a qualified hedge or of the tax-advantaged bonds with which the qualified hedge is integrated under Treas. Reg. § 1.148-4(h)(1) is treated as not terminating the qualified hedge under Treas. Reg. § 1.148-4(h)(3)(iv)(B), provided that, no later than the end of the 90-day period beginning on the date of the first covered modification of either the qualified hedge or the hedged bonds, the qualified hedge that results from any such covered modification satisfies the requirements to be a qualified hedge (determined by applying the special rules for certain modifications of qualified hedges under Treas. Reg. § 1.148-4(h)(3)(iv)(C)) with respect to the hedged bonds that result from any such covered modification).

ii. Solely for purposes of determining whether the qualified hedge that results from a covered modification satisfies the requirements to be a qualified hedge with respect to the hedged bonds that result from any such covered modification, a qualified one-time payment with respect to the hedge or the hedged bonds (or both) is allocated in a manner consistent with the allocation of a termination payment for a variable yield issue under § 1.148-4(h)(3)(iv)(H) and treated as a series of periodic payments.

iii. However, the Final LIBOR Regulations clarify that Treas. Reg. § 1.1001-6(c)(1)(iv) does not apply to hedges and bonds that are super-integrated under Treas. Reg. § 1.148-4(h)(4).

iv. From the Preamble, one commenter requested guidance on how a one-time payment is treated for purposes of the arbitrage investment restrictions and private use restrictions that apply to tax-advantaged bonds. The Treasury Department and the IRS are still considering how best to address these issues relating to qualified one-time payments. Until the Treasury Department and the IRS publish further guidance, taxpayers may continue to rely on the rule in Treas. Reg. § 1.1001-6(d) of the Proposed Regulations to determine source and character of a qualified one-time payment under the Final Regulations.

F. Rev. Proc. 2020-44

1. ***Background***. On October 9, 2020, the IRS released Rev. Proc. 2020-44 in support of the efforts of the Alternative Reference Rate Committee (ARRC)

and International Swaps and Derivatives Association (ISDA) to help market participants transition away from interbank offered rates. The Rev. Proc. notes that the interim guidance provided therein was needed prior to the finalization of the proposed Treasury Regulations discussed in subsection E. above. Generally, the Rev. Proc. provides that certain modifications to a contract with terms referencing an IBOR will not be treated as a modification that results in an exchange of property.

2. ***General Concept***. If a contract is modified with language that is recommended in one of the ARRC consultations (available at: https://www.newyorkfed.org/arrc/fallbacks-contract-language) in order to provide for a replacement or a fallback rate to an IBOR, such modification generally will not result in a reissuance. The applicable contracts that are within the scope of the Rev. Proc. include, but are not limited to, derivative contracts, debt instruments, insurance contracts and lease agreements.

3. ***Definitions.***

    i. ARRC Fallback. An ARRC Fallback is contract language recommended by the ARRC and also includes any option or variant included in the below contract language.

        a. *ARRC Recommendations Regarding More Robust LIBOR Fallback Contract Language for New Closed-End, Residential Adjustable Mortgages, Part II: Fallback Language for Closed-End, Residential Adjustable Mortgages* (dated November 15, 2019).

        b. *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans, "Hardwired Approach" Fallback Language of Part II; "Hedged Loan Approach "of Part II* (dated May 30, 2019).

        c. *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Bilateral Business Loans, Part II: Fallback Language for New Originations of LIBOR Bilateral Business Loans* (dated August 27, 2020)

        d. *ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Floating Rate Notes, Part II: Fallback Language for New Issuances of LIBOR Floating Rate Notes* (dated April 25, 2019).

        e. *ARRC Recommendations Regarding More Robust Fallback Language for New Issuances of LIBOR Securitizations, Part*

II: Fallback Language for New Issuances of LIBOR Securitizations (dated May 31, 2019).

f. *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans, "Hardwired Approach" Fallback Language of Part II: Fallback Language for New Originations of LIBOR Syndicated Loans* (dated April 25, 2019).

g. *ARRC Recommendations Regarding More Robust Fallback Language for New Originations of LIBOR Syndicated Loans, Part II: Fallback Language for New Originations of LIBOR Syndicated Loans* (dated June 30, 2020).

h. *ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Variable Rate Private Student Loans, Part II: Fallback Language for New Variable-Rate Private Student Loans* (dated June 30, 2020)

ii. ISDA Fallback. An "ISDA Fallback" is the set of terms provided in any one of the sections numbered one through six in the version of the Attachment to the ISDA Protocol available as of October 9, 2020 at https://www.isda.org. These sections set forth various terms based on the year of ISDA definitions that were used in the applicable swap documents.

4. ***Types of Covered Modifications***. The types of modifications that are permitted under the Rev. Proc. are:

i. Modifications to incorporate an ISDA Fallback, regardless of whether that modification results from adherence to the ISDA Protocol or a bilateral agreement between the parties to the contract

ii. The contract is modified to incorporate an ARRC Fallback.

iii. The contract is modified to incorporate the terms of either an ARRC Fallback or an ISDA Fallback with certain deviations, provided all deviations fall into one or more of the following categories:

a. Deviations from the terms of an ARRC Fallback or an ISDA Fallback that are reasonably necessary to make the terms incorporated into the contract legally enforceable or satisfy legal requirements of the jurisdiction.

b. Deviations from the terms of an ISDA Fallback that are reasonably necessary to incorporate the ISDA Fallback into a contract that is not a Protocol Covered Document (as defined in the ISDA Protocol)[2].

c. Deviations from the terms of an ARRC Fallback or an ISDA Fallback to omit terms of an ARRC Fallback or an ISDA Fallback that cannot under any circumstances affect the operation of the modified contract (for example, in the context of a LIBOR contract, omission of portions of an ISDA Fallback that relate exclusively to contracts referring to another IBOR).

5. ***Effective Date***. Rev. Proc. 2020-44 is effective for modification to contracts occurring after October 9, 2020, and before January 1, 2023. However the Rev. Proc. may be relied upon for modifications occurring before October 1, 2020.

[2] This generally includes Master Agreements, Supplements and Confirmations entered into between a borrower and a counterparty.