20. REFUNDINGS AND REISSUANCE

Chair:

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The three sessions of this Panel (one review session and two intermediate sessions) will address issues in refundings and reissuances. All three will be interactive and focus on recent developments.

Refundings and Reissuance

One review and two intermediate sessions will discuss and analyze a variety of common and uncommon reissuance triggers (both intentional and unintentional) that may present in today's current market through a discussion of various practical hypotheticals. All sessions will also discuss key tax issues of current interest in 2016 that may arise in a variety of refunding transactions, including the application of the transferred proceeds and multipurpose allocation rules in advance refunding transactions. The review session is designed to appeal to attendees interested in reacquainting themselves with the "fundamentals" of the applicable federal tax rules pertaining to refunding and reissuance transactions, while the intermediate sessions are designed to appeal to attendees with a working knowledge of such applicable federal tax rules.

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This Refunding and Reissuance outline has been prepared and updated annual as a cumulative effort by the NABL members who have generously served as Steering Committee Chair of the Refunding and Reissuance panel at Bond Attorneys Workshop.

PART A – REFUNDINGS

I. What is a Refunding?

A. Definition. A refunding issue is generally defined in the Treasury Regulations as an issue the proceeds of which are used to pay principal, interest or redemption price on another (prior) issue generally having the same or related obligor, including issuance costs, accrued interest, a reserve or replacement fund or similar costs properly allocable to that refunding issue.[1]

The above is clearly an over-simplification. There are several nuances and exceptions to the above definition. Note that a refunding may take different forms including a new bond issue or a modification of an existing bond issue that is treated for tax purposes as a new bond issue. There are also transactions that are treated as refundings for some purposes but not others (so called "hybrid issues").

B. Mechanics of a Refunding. A refunding involves the issuance by a state or local governmental entity of new bonds, the proceeds (either the sale proceeds of the bond issue or the investment earnings thereon) of which are used (or allocated) to pay debt service (principal, interest, or call premium) on another issue of the governmental entity's bonds. If the refunded bonds are not retired immediately or soon after issuance of the refunding bonds, the refunding bond proceeds are usually deposited into an escrow account with a trustee to provide for such payment.

C. Exceptions from Definition of Refunding.

1. In certain transactions in which an acquiror of assets (i) assumes (or takes the assets subject to bonds of the transferor) and (ii) shortly thereafter refinances the bonds, the refinancing bonds are treated in some circumstances as "acquisition" bonds rather than refunding bonds for federal tax purposes.[2]

2. The payment of interest on an existing issue that accrues during a one-year period that includes the issue date of the issue that finances such interest generally will not be treated as a refunding transaction. Treas. Reg. § 1.150-1(d)(2)(i)(A). This exception does not apply if any principal is paid from the issue.

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[1]Treas. Reg. § 1.150-1(d). Unless otherwise noted, regulatory references are to current Treasury regulations. Unless otherwise noted, statutory references are to the Internal Revenue Code of 1986, as amended.

[2]Treas. Reg. § 1.150-1(d)(2)(v). On April 10, 2002, the IRS issued proposed regulations that would alter the definition of refunding and cause certain transactions that might otherwise be treated as acquisition or "new money" transactions to be characterized as refunding transactions. Prop. Treas. Reg. § 1.150-1(d)(2)(ii) and (v). These regulations, among other things, would create a low threshold for there being an affiliation for tax purposes between two or more entities. These regulations are not yet finalized. A more detailed discussion of these regulations is contained in IX.G of Part A of this outline.

3. The payment of interest only (not principal) on another bond issue during the construction period of the facility financed by the prior bond will be treated as a new money financing of capitalized interest and not as a refunding for federal tax purposes. Treas. Reg. § 1.150-1(d)(2)(i)(B).

4. The payment of interest that falls under one of the *de minimis* working capital rules of Treas. Reg. § 1.148-6(d)(3)(ii)(A) will not be treated as a refunding transaction.[3]

5. The IRS has ruled that the use of amounts released from a parity reserve fund, as a result of the substitution of a bond insurance policy, to redeem a portion of the bonds secured by such reserve fund did not cause the bond issues from which the amounts so used were derived to become refunding issues. PLR 200441021.

D. Defeasance. The word "defease" is used for convenience well beyond its actual meaning. If a bond issuer has a covenant with bond holders, that covenant may be defeased if the operative bond documents or state law allows. Once the covenant is defeased the covenant has no force of law. Bondholders may not enforce a covenant once it has been defeased. Generally some bond documents provide that many or all covenants with the bond holders are defeased if the payments of principal and interest on the bonds are provided for with investments of a sufficiently high quality. For example it is common for revenue bonds to contain rate covenants. Those rate covenants are generally defeased if cash and direct obligations of the United States that produce cash flows sufficient to pay all principal of and interest on the bonds are placed in an irrevocable escrow account. Being sufficient requires that they will be projected to be received by the escrow agent before or at the same time that the bond payments are due. As a convenience, people will say that the bonds are defeased if a sufficient escrow is provided for those bonds. People will also say that certain cash flows or certain investments defease certain bond payments (or the bonds as a whole) if those cashflows or investments are sufficient to pay those payments both in amount and time. A defeasance of a bond involves a formal release of the lien of the bondholders on the pledged assets or revenues in exchange for the pledge of cash or highly rated securities sufficient to repay the bond. The source of the funds need not be from refunding bond proceeds. While many refundings involve a defeasance of the prior bonds, that is not always the case, and the distinction can be important. For tax purposes, defeased bonds generally continue to be outstanding and subject to tax restrictions (*e.g.,* rebate must still be calculated and paid on bonds that are advance refunded). However in some instances (principally involving taxable bonds), defeasance of a bond may cause the bond to be treated as "reissued." (See Part B – Reissuance under Treas. Reg. § 1.1001-3 and Notices 88-130, 2008-41, 2008-88 and 2010-7 of this outline for a detailed discussion.)

E. Legal vs. In-Substance Defeasance. If the prior bond cannot be legally defeased or if the defeasance provisions have not been fully satisfied, the prior bond might alternatively be

[3]Treas. Reg. § 1.150-1(d)(2)(i)(C). This exception would appear to have limited applicability since one or at most two of the *de minimis* rules would apply to the payment of interest from other than a specifically designated source.

defeased on an "economic," or an "in-substance," basis if U.S. Treasury obligations or other highly rated securities are deposited in an escrow to retire the bond.

F. Reissuance. Under Code Section 1001, Treasury Regulations Section 1.1001-3 and Notices 2008-88, 2010-7, 2008-41, and 88-130, tax-exempt bonds the terms of which are modified after issuance may be treated as "reissued." When a reissuance occurs, the bonds that were outstanding immediately prior to modification are deemed retired and the modified bonds are deemed to have been newly issued to currently refund the unmodified bonds. See Part B – Reissuance under Treas. Reg. § 1.1001-3 and Notices 88-130, 2008-41, 2008-88 and 2010-7 of this outline for a detailed discussion.

G. Advance vs. Current Refundings. A current refunding is defined as a refunding in which the prior bonds are redeemed within 90 days of the date of issue of the refunding bonds. See III.A.

H. Taxable and Tax-exempt Refundings. Often taxable bonds are used to refund tax exempt bonds, particularly when the refunded bond is not eligible for a tax-exempt advance refunding. In certain markets, taxable refundings may produce greater savings (or lesser loss) than tax-exempt refundings. Less frequently, taxable bonds are refunded with tax-exempt bonds, often because the reason for taxability disappears, but sometimes because the taxable bonds could have been issued on a tax-exempt basis but were not.

I. High-to-Low vs. Low-to-High Refundings. Refundings may be categorized as either "high-to-low" refundings or "low-to-high" refundings.

1. A high-to-low refunding involves the refunding of a high coupon prior bond with lower interest rate bonds for interest rate savings and calling the prior bond before its maturity.

2. By contrast, a low-to-high refunding generally involves escrowing the prior bond to maturity, and is usually undertaken for reasons other than interest rate savings, for example: (i) to remove burdensome covenants; (ii) to lengthen or otherwise restructure debt service; or (iii) to produce economic benefits other than interest rate savings.

3. Many refundings involve more than one purpose and the dominant motives within the market will vary over time.

J. Prior Issue. The definitions of "prior issue" and "refunding issue" are intertwined. Bonds that are refunded constitute a "prior issue." Treas. Reg. § 1.150-1(d)(5). Interestingly, "[a] prior issue may be issued before, at the same time as, or after a refunding issue." It is very difficult to intentionally plan for a refunding issue that is not issued after the prior issue it refunds. More likely, this language is intended to force the consequences of refunding transactions (e.g., transferred proceeds) on issues that are converted into refundings of later prior issues (possibly inadvertently).

II. <u>Economics of Refundings</u>.

A. <u>High-to-Low Refundings</u>.

1. <u>In General</u>. A high-to-low refunding is, in effect, the exercise by the issuer of an in-the-money call right on a callable prior bond on the call date at the redemption price. In an advance refunding, the exercise of the call right has been effected in advance of the actual call date through an escrow for the prior bonds, but the net effect is the same. The corollary of this analysis is that, unless the prior bond is callable, there can be no interest rate savings on a refunding of the bond. And like any exercise of a call option, the value received for the exercise of the option is a function of many variables. For refundings, those variables include: (i) the interest rate on the prior bonds; (ii) the yield on the new bonds; (iii) the maturity date of the prior bonds; (iv) the call date of the prior bonds; (v) the call premium on the prior bonds; (vi) costs of issuance of the refunding issue; (vii) the available yield on the refunding escrow investment portfolio, and in particular the phenomenon of "negative arbitrage"; (viii) possible rebate on funds held by the issuer in connection with the refunding issue; and (ix) in certain cases, transferred proceeds penalties that are incurred as a result of the refunding.

2. <u>Old Coupon vs. New Yield</u>. The higher the coupon on the prior bonds relative to today's market yields, the greater are the savings.

3. <u>Negative Arbitrage</u>. In almost all advance refundings today the escrow is invested below the yield on the bonds. This means that savings is reduced. Shorter escrows tend to produce greater savings.

4. <u>Maturity of Prior Bonds</u>. A bond with a relatively short period of time between the call date and the maturity date will have a relatively low level of savings because the value of the interest rate differential (old coupon vs. new yield) is small relative to the fixed costs of the refunding transaction. The longer the period between the call date and the maturity date of the prior bonds, however, the more interest savings may be realized.

5. <u>Call Date of Prior Bond</u>. The earlier the call date, the greater is the period of time over which the interest rate differential is realized and the greater is the level of savings.

6. <u>Call Premium and Issuance Costs</u>. These costs are simply the premium and transactional costs that an issuer must incur to exercise its call option. Obviously, the higher these costs, the lower the level of savings the issuer will realize.

7. <u>Escrow Investment Yield</u>. Under the arbitrage rules, an issuer may not invest the portion of the escrow funded with advance refunding bond proceeds at a yield materially above the yield on the refunding issue (current refunding escrows, by contrast, can be invested without regard to yield for 90 days after the current refunding bonds are issued, although it is extremely rare that investments during the 90-day period will general arbitrage profits). Thus, if the market rate for the escrow investments is 5% while the advance refunding bond yield is 4%, the issuer will be limited to a 4% rate of return on the refunding escrow. This is generally accomplished via the purchase of U.S. Treasury Securities – State

and Local Government Series ("SLGs"). There is no guarantee, however, that the issuer will be able to invest the advance refunding escrow at a yield as high as the refunding bond yield. If the market rate is 3%, the issuer will earn only 3%. The difference between the 3% market rate and the 4% yield on the refunding issue is known as "negative arbitrage."

8. Rebate and Transferred Proceeds Penalties. These are economic costs that the federal tax laws impose on refundings, discussed below.

9. Issuer Level of Savings Targets. Many issuers have established criteria 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 in order to undertake a refunding. Percentage savings tests vary widely. In addition, notwithstanding the level of potential savings that may be derived from refunding a particular bond, the absolute dollar level of savings may not make it worthwhile for an issuer to undertake the time, expense, and effort of issuing refunding bonds, even if the percentage level of savings is very high.

10. Accounting Treatment. Accountants and other professionals should review any refunding plan for possible accounting consequences or other non-tax consequences of refunding transactions. For example, costs of issuance capitalized in a prior transaction may need to be re-amortized or accelerated when bonds are refunded.

B. Refunding for Other Purposes.

1. Defeasance. By its nature, a refunding for the purpose of defeasing outstanding debt to remove burdensome covenants generally will be limited to the refunding of older revenue bonds. Sometimes it is used to remove burdensome covenants of a bond insurer of the refunded bonds.

2. Restructuring of Debt Service. During recessionary periods, many states and localities undertake refundings to defer or stretch out their existing debt service, particularly within the current or immediately succeeding fiscal year. These are sometimes referred to as "scoop and toss" refundings. Because bond debt service is deferred, the issuer must separately ensure bonds are not being left outstanding longer than necessary.

3. Changing the Source of Payment. Sometimes a bond will be refunded to change the source of payment from, for example revenue to G.O. or vice versa. In some cases debt is issued that is expected to be refunded after a state law waiting period.

4. Bond Anticipation Notes. Some short term obligations are designed to be refunded (often called Bond Anticipation Notes). For example state law may allow certain types of obligations to be issued immediately, but require a waiting period for possible petitions to prevent the issuance of permanent long term financings. Such temporary obligations are then issued with the full expectation of having them refunded in short order.

5. Economic Considerations. While refundings other than for interest rate savings do not require the exercise of a call right to accomplish their objectives, many of the other considerations that are factors for high-to-low refundings will pertain to these refundings as well. These include costs of issuance on the refunding issue, negative arbitrage on the refunding

escrow (particularly in the case of refundings to lengthen debt service), rebate on proceeds of the refunding issue, and transferred proceeds penalties. As discussed above in Section II.A.9., accountants and other professionals should review any refunding plan for possible accounting consequences or other non-tax consequences of refunding transactions.

III. Federal Income Tax Law Limitations on the Ability to Refund.

A. Current vs. Advance Refundings. The federal tax law creates significant distinctions between a "current refunding" and an "advance refunding."

1. A current refunding is defined as a refunding in which all of the bonds of the prior issue are called or mature within 90 days after the issuance of the refunding bonds. All other refundings are advance refundings. Treas. Reg. § 1.150-1(d)(3)-(d)(4). When a particular bond interest payment is refunded (but see the refunding bond definition exception above) and that interest payment is no more than 90 days after the refunding bonds are issued, then that interest payment may be included in the current refunding even if the principal of that bond (not refunded) is payable more than 90 days after the refunding bond issuance. Note that the test is made separately for each "Prior Issue." However, if one principal payment on a prior issue will be paid from refunding bond proceeds within 90 days while another principal (or interest) payment on the same prior issue is paid more than 90 days after the refunding bond date of issuance, the entire refunding of that prior issue is an advance refunding.

2. For refundings undertaken prior to January 1, 1986, a current refunding was one in which the prior bonds were called or matured within 180 days after the issuance of the refunding bonds. *See, e.g.,* Treas. Reg. § 1.103-15 (1979). In addition, pre-1986 refundings of certain bond anticipation notes (outside of 180 days) were treated as current refundings. *See* Treas. Reg. § 1.150-1(d)(3).

3. In the context of a pooled loan financing in which loans are made to governmental borrowers, the date of issuance of the pooled financing bonds, and not the date of origination of a pooled loan, is the relevant date for determining whether the repayment of a tax-exempt obligation by a governmental borrower is treated as a current refunding or an advance refunding. Rev. Rul. 2003-78, 2003-2 C.B. 76.

B. Permitted Types of Advance Refundings. Advance refundings have long been out of favor with tax policymakers in Washington. They view advance refundings as creating two sets of tax-exempt bonds in the hands of the investing public (and thus double the federal tax-exempt interest "subsidy") for only one project. Therefore, Congress and the IRS have sought to limit advance refundings both directly (with explicit limits on advance refundings) and indirectly (by imposing costs and eliminating profit opportunities). Under federal tax laws, only three types of advance refundings are permitted:

1. Net Cash Refunding. The dominant type of refunding is a net cash refunding in which the principal, interest, and call premium on the prior bonds are paid with the proceeds of the refunding issue. Proceeds of the refunding bonds are deposited in an

escrow in an amount sufficient to purchase investment obligations (usually Treasuries) that will produce a cash flow that will timely pay the remaining debt service on the prior bonds.

2. Crossover Refunding. In a crossover refunding, the escrow pays interest on the *refunding* bonds through the call date of the prior bonds, and then pays the principal and call premium of the *prior* bonds on the call date. In this way, the refunding bond issue "pays for itself" through the period to the redemption of the prior bonds, after which time the debt service on the refunding bonds is paid from the revenue stream that would have been used to pay debt service on the redeemed prior bonds. Conversely, until their redemption, interest on the prior bonds continues to be a liability of the issuer (and no gross proceeds of any refunding issue may be used to pay interest on the prior bonds); thus, the prior bonds are not defeased and removed from the issuer's balance sheet. Because the refunding bonds pay for themselves and no defeasance of the prior bonds is being sought, the issuer has substantially greater flexibility under the bond documents to use investments other than Treasuries in the refunding escrow. The issuer thereby has the potential to earn a higher yield (particularly useful in periods of negative arbitrage), which is the major reason why many crossover refundings are undertaken. *See* Treas. Reg. § 1.148-10(c)(4).

3. Full Cash Refunding. Also known as a "gross" refunding, a full cash refunding is an archaic type of refunding and is undertaken only if the prior bond resolution or trust indenture requires an initial deposit to the escrow of the full amount of the principal, interest, and call premium of the prior bonds, disregarding any interest that may be earned on the refunding escrow. Since the escrow will generate investment income that exceeds the amount required to retire the prior bonds, a full cash refunding is structured with two series of bonds. The excess investment income is used to pay the debt service on one series of the refunding bonds known as "special obligations bonds." The other series of the refunding bonds is paid by the issuer, with the net economic effect to the issuer being substantially the same as if it had done a net cash refunding. Full cash refundings are rare in part because the tax regulations preclude such a refunding unless bond documents that were effective prior to November 6, 1992, require it. *See* Treas. Reg. § 1.148-10(c)(5). In fact however these refundings have been rare since well before 1992.

C. Statutory Restrictions on Advance Refundings.

1. Number of Refundings. The first direct limitation on advance refundings is an explicit statutory limitation on the number of "generations" of advance refundings a governmental issuer may undertake. If the original "new money" financing was issued on or after January 1, 1986, those bonds (or any successor current refunding bonds) may be advance refunded only once. New money bonds issued prior to January 1, 1986, may be advance refunded twice. All advance refundings done prior to March 15, 1986, however, count as only one advance refunding for purposes of the advance refunding limit. Code Section 149(d)(3) and 149(d)(6). The debt service of the prior issue that has not been paid by proceeds of an advance refunding bond is treated as not having been advance refunded. Treas. Reg. § 1.149(d)-1(c). To provide economic relief to certain New York issuers in the aftermath of September 11, 2001, the Job Creation and Worker Assistance Act of 2002 was enacted to permit one additional advance refunding of certain bonds. Likewise, the Gulf

Opportunity Zone Act of 2005 provides an opportunity for certain issuers to undertake an additional advance refunding of bonds in the aftermath of Hurricane Katrina.

2. Private Activity Bonds. Private activity bonds (other than qualified 501(c)(3) bonds) may not be advance refunded. Code Section 149(d)(2). This generally includes all "AMT" bonds (i.e., bonds subject to AMT), single family and multifamily housing bonds, certain bonds for airports and docks and wharves, solid waste revenue bonds, and other bonds issued for the benefit of private parties.

3. First Call Rule. If the refunding of prior bonds may produce present value savings, the prior bonds must be called on the first call date. Code Section 149(d)(3)(A)(ii) and (iii). This rule is an attempt to limit the amount of "doubling up" in the tax-exempt market that results from advance refundings. This rule has been substantially altered by application of the multipurpose allocation rules of Treas. Reg. § 1.148-9(h), described below. Under these rules, if the refunding of a prior "issue" (as defined in the multipurpose allocation rules) increases the present value savings of the entire multipurpose issue, then that prior issue must be called on the first call date. Treas. Reg. § 1.149(d)-1(f)(3).

4. Profitability. The major indirect limitation aimed at limiting the profitability of advance refundings is the requirement, mentioned before, that the yield on the portion of the escrow fund provided from refunding bond proceeds may not be invested at a yield materially above the yield of the refunding issue.[4] An additional rule recalculates the refunding bond yield to eliminate reduced costs of credit enhancement on refunded bonds.

5. Prohibited Devices. Certain rules that are applicable only to advance refundings prohibit certain financing techniques from being utilized in an advance refunding. These so-called "devices" to obtain a material financial advantage (based on arbitrage) are identified in the legislative history of the Tax Reform Act of 1986 as follows:

a. The transfer of refunded bond debt service fund amounts to the long end of the escrow and the investment of those amounts at a higher yield than the refunding bond yield (or any other material financial advantage other than interest rate savings) (the "debt service fund flip flop").

b. The transfer of refunded bond proceeds in a construction fund to the escrow fund and the investment of those amounts at a higher yield than the refunding bond yield (or any other material financial advantage other than interest rate savings), with the construction fund being replenished from new bond proceeds (the "construction fund flip flop").

c. Failure to take into account in computing the yield on the refunding bonds a rebate of an insurance premium paid on refunded bonds as a result of the refunding.

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[4] *See* Treas. Reg. § 1.148-5(b)(2)(iv); *but see* Treas. Reg. § 1.148-5(b)(2) on separate classes of investments and permitted yield blending.

d. Failure to take into account in computing the yield on the refunding bonds a reduction in the coupon on the refunded bonds as a result of the refunding (a "reduced coupon refunding").

e. The issuance of a short-term taxable issue and a separate, long-term tax-exempt issue, with the proceeds of the taxable issue invested in the escrow fund at a yield higher than the yield on the two refunding issues, or the issuer otherwise secures a material financial advantage by separating the two issues (a "taxable/tax-exempt refunding").

f. In addition, any other device that produces a "material financial advantage based on arbitrage" other than "interest rate savings" can be identified and prohibited by the IRS through regulations or revenue rulings. Code Section 149(d)(4) and (d)(7).

6. There may also be industry-specific limitations or "rifle-shot" transition rule exceptions that will affect the ability of an issuer to advance refund bonds. For example, 501(c)(3) organizations are limited to a $150 million volume cap on the amount of bonds used to finance nonhospital projects; both advance refunding bonds and the refunded prior bonds count against the $150 million cap until the prior bonds are retired. Although the $150 million cap was repealed with respect to most "new money" bonds issued after August 5, 1997, the limitation continues to apply to bonds originally issued prior to that date and certain bonds used for more than a de minimis amount of working capital. Code Section 145(b)(5).

D. Limitations on Current Refundings. As more fully discussed below, there are relatively few limitations on current refundings. The limitation that has the most direct economic impact on a refunding of most private activity bonds (but not qualified 501(c)(3) bonds) is a rule that exempts the refunding bond issue from volume cap if the "amount" of the refunding bonds does not exceed the "amount" of the prior bonds. See Section 146. This rule generally means that the issuer must contribute equity to the refunding to cover its cost of issuance, any call premium on the refunded bonds, interest on the refunded bonds and any negative arbitrage on the current refunding escrow or must apply for and receive volume cap for the portion of the "amount" of the refunding bonds that exceeds the "amount" of the prior bonds. For a discussion of what the "amount" of bonds is for these purposes, see V.A of Part A below.

E. Other Limitations.

1. Transferred Proceeds. If there are unspent proceeds of the prior issue, one limitation that can apply is the imposition of a "transferred proceeds penalty." "Transferred proceeds" are amounts that were unspent proceeds of the prior issue that become treated as proceeds of the refunding issue as principal is paid on the prior issue using proceeds of the refunding issue. Transferred proceeds are subject to yield restriction based upon the yield on the refunding issue. See VI.C. below. The transferred proceeds penalty, applicable to both current and advance refundings, occurs most often in a high-to-low current refunding of a prior issue that was itself an advance refunding with a still outstanding escrow. This penalty can significantly reduce or even eliminate savings that would otherwise be generated from a refunding. The penalty is an economic adjustment to the yield on the refunding escrow

equal to the present value of the difference between the yield on the escrow established with the prior bond proceeds and the yield on the refunding bond issue from and after the call date of the prior bond. For example, a 2002 bond issue with a 6% yield used to refund on a low-to-high basis a 1994 bond issue would have a long-term escrow with a yield of 6%. If the 2002 bond issue were to be currently refunded with a 2009 bond yielding 4%, the issuer would suffer a penalty equal to the value of the difference between the 6% actual investment yield on the 2002 escrow and the new 4% refunding yield, from and after the call date of the 2002 bond issue. Section 1.148-5(c)(3)(i)(C)(1) of the Regulations allows the issuer to make a yield reduction payment to the United States rather than requiring that the escrow established with the 2002 bond issue be restructured. See IV.G.2. below. That penalty can be equal to the savings on the refunding (ignoring costs of issuance and call penalty), thus eliminating any incentive on the issuer's part to undertake the refunding. The existence of this penalty is the reason some high-coupon non-private activity bonds have not been advance refunded. This penalty, however, does not apply to taxable refundings or to a defeasance with the issuer's own revenues, because the proceeds of the prior issue do not become subject to new yield restriction limits as a result of the refunding or defeasance.

2. Rebate. Most issuers must pay "rebate" on various bond-related accounts, including any debt service reserve funds. The rebate requirement was imposed upon most tax-exempt issues by the Tax Reform Act of 1986 and requires that 100% of the investment earnings in excess of the bond yield be rebated to the U.S. Treasury. The actual amount of rebate due on a particular refunding issue depends upon the issuer's investment strategy and the aggregate bond yield on the refunding issue; all else being equal, the lower the yield on the refunding issue, the greater the amount of rebate. This amount cannot be determined in a generalized manner, but the requirement potentially affects almost every refunding bond issue having a debt service reserve fund, especially when refunding a pre-1986 bond that was not subject to rebate (since the reserve will be subjected to rebate for the first time). In addition, when the prior issue is entirely paid off, a final rebate payment (if any rebate is due) must be paid within 60 days after retirement of the prior issue.

3. Universal Cap. If a refunding bond issue is paid down faster than the escrow funded by such refunding bond issue is spent, the unspent proceeds of the refunding issue may be "freed up" and no longer treated as proceeds of the refunding bond issue.

4. Multipurpose Allocation Rules. One area in which the IRS has provided issuers with some flexibility is in the refunding of a prior issue that was issued partly for refunding purposes and partly for new money needs or was issued to refund two or more prior issues. *See* Treas. Reg. § 1.148-9(h). In such instances, the issuer may designate specific maturities for one purpose or the other, and the bonds so designated will be treated as separate issues for purposes of the limits on the number of advance refundings and for purposes of computing transferred proceeds penalties (see below). This rule has allowed issuers to selectively advance refund portions of prior bond issues without running afoul of

some of the prohibitions and penalties of the federal tax law.[5] Similar multipurpose rules apply to private use questions under Treas. Reg. § 1.141-13(d).

5. Anti-Abuse Rules. In addition to the prohibited devices described above, general anti-abuse rules are set forth in Treas. Reg. § 1.148-10 that attempt to define the concept of "abusive arbitrage devices" as well as give specific examples. Among the anti-abuse rules are limitations on "excess gross proceeds," aimed at forcing the economic benefits to issuers of net cash, full cash and crossover refunding to be the same and limit the amount of advance refunding proceeds not used for specified purposes to 1% of the sale proceeds of the issue. Treas. Reg. § 1.148-10(c).

F. Certain Consequences of Refundings under ARRA.

1. Bonds Authorized by American Recovery and Reinvestment Tax Act of 2009 ("ARRA"). The categories of tax-favored bonds (some of which can no longer be issued) that were created or extended by ARRA, e.g., Build America Bonds, qualified school construction bonds, recovery zone facility bonds, etc., generally may not be issued to refund prior bonds, regardless of whether the prior bonds were bonds of the same type, tax-exempt bonds or taxable bonds. This prohibition significantly increases the importance of avoiding a reissuance (discussed below in Part B) of these bonds. A limited exception to the refunding prohibition applied to Build America Bonds (Notice 2009-26) and certain direct payment qualified tax credit bonds (i.e., new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds issued as direct payment, rather than tax credit, bonds) (Notice 2010-35). The exception allows those bonds to refinance certain short-term obligations issued in anticipation of the refinancing bonds by treating such a refinancing as a reimbursement rather than a refunding. Note that such bonds are analyzed for all tax purposes as new money bonds and not refunding bonds. For example the temporary periods for the project fund begin on the date of the ARRA bonds not the temporary financing bonds. These ARRA Bonds do not have transferred proceeds.

2. Alternative Minimum Tax ("AMT"). Interest on tax-exempt private activity bonds ("PABs"), other than qualified 501(c)(3) bonds, that were issued other than from January 1, 2009 through December 31, 2010, is generally an item of tax preference for purposes of the individual and corporate AMT. Code Section 57(a)(5). (This excludes certain housing bonds issued on or after July 31, 2008 and also excludes bonds issued before 1986 and certain refundings of those.) Interest on certain other tax-exempt bonds issued before January 1, 2009 or after December 31, 2010 is included in "adjusted current earnings," 75%

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[5]See, *e.g.,* PLR 200315012, in which an issuer of pooled financing bonds a portion of the proceeds of which would be used more than 90 days after the date of issuance of such bonds to refund the debt of pool borrowers was permitted to treat such advance refunding portion of the issue as a separate issue under Treas. Reg. § 1.148-9(h) for purposes of Section 149(d)(3)(A)(i) (number of advance refundings rule), (ii) (first call rule for pre-1986 issues) and (iii) (first call rule for post-1985 issues) and to make a reasonable, consistently applied allocation of bonds, proceeds and investments to such portion of the issue.

of the excess of which over alternative minimum taxable income (before certain adjustments, including this adjustment) is included in alternative minimum taxable income, which is subject to the corporate AMT. Code Section 56(g)(4)(B). Under ARRA, the foregoing AMT treatment does not apply to non-refunding tax-exempt obligations (PABs or governmental use bonds) issued during 2009 or 2010; that is, interest on these bonds is not an item of tax preference and is not included in adjusted current earnings. Code Sections 57(a)(5)(C)(vi) and 56(g)(4)(B)(iv). For this purpose, refunding obligations are generally treated as issued on the issuance date of the new money obligations that they directly or indirectly (in the case of a series of refundings) refund. For example, a refunding bond issued in 2012 to refund a new money bond issued in 2009 will be a "non-AMT bond." A special rule however suspends this look-back for the first refunding of a prior issue issued in 2004 through 2008. Such refunding bonds issued in 2009 or 2010 receive the favorable AMT treatment. This is true even if the refunded bond was itself a refunding bond and the original new money bond was issued before 2004. However, when those refunding bonds are refunded another time (whether in 2009, 2010, or later), that later refunding bond does not get the favorable treatment. Rather one looks back to the issue date of the new money bond at the beginning of the chain. This dynamic significantly increases the importance of avoiding a reissuance of the 2009/2010 refunding bonds.

3. Qualified Tax-Exempt Obligations ("QTEOs"). QTEOs are favored by banks because a bank's interest expense allocable to a QTEO is generally deductible (other than a 20% disallowance). For bonds issued in 2009 and 2010, ARRA increased the QTEO limit from $10 million to $30 million and applied that limit to the conduit borrower in the case of qualified 501(c)(3) bonds and certain pool bonds. Code Section 265(b)(3)(G). Pre-2009 bonds that were not issued as QTEOs could have been refunded by QTEOs issued by an issuer that did not exceed the $30 million limit (or, in the case of qualified 501(c)(3) bonds or certain pool bonds, where the conduit borrower will not exceed the $30 million limit) in the year of the refunding and thereby take advantage of the current higher QTEO limit. The $30 million limit reverted back to its former $10 million limit for bonds issued on January 1, 2011 and thereafter. ARRA also extended the "2% de minimis" rule to financial institutions for bonds issued in 2009 and 2010. However, pre-2009 bonds cannot be made eligible for this de minimis rule by a refunding because a refunding bond (whether a current or advance refunding) is treated as issued on the date of issuance of the refunded bond (or in the case of a series of refundings, the original bond). Code Section 265(b)(7). However once bonds are subject to this 2% rule, refunding bonds that refund them are also eligible. Thus even though new money bonds issued in 2011 or beyond are not eligible for the 2% de-minimis treatment, refundings of such bonds issued in 2009 or 2010 are eligible.

IV. Arbitrage Rules Applicable to Advance Refundings.

A. Yield on Investments.

1. Yield Limit. Bond proceeds in advance refunding escrows (other than a minor portion) may not be invested to produce a yield greater than bond yield plus .001%. Treas. Reg. § 1.148-2(d)(2)(ii).

2. Separate Classes of Investments. The current regulations treat each of the following as a separate class of investments: (i) yield-restricted nonpurpose investments; (ii) program investments; (iii) student loans; (iv) tax-exempt purpose and program investments; (v) all other purpose investments; and (vi) all other nonpurpose investments. Treas. Reg. § 1.148-2(d)(2); Treas. Reg. § 1.148-5(b)(2).

3. Separate Yields. The yield on each such class must be computed separately, *i.e.,* yield "blending" is permitted within a class of investments but no blending of yield is permitted among these classes. Treas. Reg. 1.148-5(b)(2). Prior law recognized only two classes – purpose and nonpurpose. Treas. Reg. § 1.103-13(b)(4)(iv) (1979).

4. No Yield Reduction Payments. Gross proceeds of an advance refunding issue are generally not eligible for yield reduction payments. Treas. Reg. § 1.148-5. Thus an advance refunding escrow must actually be yield restricted without regard to the possibility of payments to the IRS. However, Treas. Reg. § 1.148-5(c)(3)(viii) provides that yield reduction payments may be made when SLGs are unavailable. Additionally, Treas. Reg. § 1.148-5(d)(3)(ix) allows issuer to make yield reduction payments with respect to nonpurpose investments allocable to proceeds of certain variable yield advance refunding issues.

5. Special Rule for "Mixed Escrows." In one of the strangest regulatory provisions applicable only to advance refundings, Treas. Reg. §1.149(d)-1(b)(3) provides that if tax-exempt and taxable investments are both included in an advance refunding escrow, then (with certain exceptions) the combined yield on the tax-exempt investments and the taxable investments must be below the bond yield plus .001%. This is the only time that the tax regulations require computing the yield on tax-exempt investments subject to arbitrage rules.

B. Rebate

1. Blending Between Escrow and Sinking Fund for Rebate Purposes. In the case of yield-restricted nonpurpose investments, yield blending is permitted between a refunding escrow and an invested sinking fund for that refunding issue only if it was reasonably expected on the issue date that the sinking fund would be established and maintained to reduce the yield on the refunding escrow. Treas. Reg. § 1.148-5(b)(2)(iii). This rule applies for all purposes of Code Section 148, *i.e.,* for yield restriction and rebate purposes. Combined treatment for yield restriction is however automatic (see above).

2. Single Investment. All yield-restricted investments allocable to proceeds of a refunding issue (*i.e.,* sale proceeds, investment proceeds and transferred proceeds) held in one or more refunding escrows are treated as a single investment with a single yield for all purposes of Code Section 148 (yield restriction and rebate) whether or not held concurrently. Treas. Reg. § 1.148-5. Thus, for example, the calculation of the yield on an escrow may take into consideration a subsequent investment in SLGs with a zero percent interest rate purchased near the end of the escrow term to reduce the overall yield of the escrow.

3. In some cases, rebate may be owed with respect to a yield restricted escrow because the yield restriction takes into account investments that are not treated as a single investment as above. In such cases, it may be necessary to pay rebate and then later request a refund.

C. Final SLG Regulations. On June 30, 2005, final regulations relating to the issuance of SLGs were published in the Federal Register. These regulations made significant changes to the previously applicable SLG regulations with respect to Time Deposit SLGs. Among the more significant of such changes are the following:

a. an issuer may not cancel a SLG subscription unless it establishes to the satisfaction of the Treasury that the cancellation is required for reasons unrelated to the use of the SLGs program as a cost-free option;

b. if an issuer purchases SLGs with amounts received from the sale or redemption before maturity of a marketable security, the yield on the SLGs may not exceed the yield at which the marketable security was sold or redeemed;

c. if an issuer purchases SLGs with amounts received from the redemption before maturity of other SLGs, the yield on the SLGs being purchased may not exceed the yield that was used to determine the amount of redemption proceeds of the redeemed SLGs;

d. an issuer is limited in changing the principal amount of a SLG subscription to 10% of the amount originally subscribed for (eliminating the $10 million floor, which was helpful to smaller issuers);

e. the issuer may delay the issue date of SLGs up to seven days after the original issue date only if it is established to the satisfaction of the Treasury that the change is required as a result of circumstances that were unforeseen at the time of subscription and are beyond the issuer's control;

f. the interest rate on SLGs is one basis point below current Treasury borrowing rates (a change from the previous 5-basis point spread);

g. the SLGSafe program is mandatory; and

h. sources of funds that may be used to purchase SLGs include: (i) amounts that constitute gross proceeds of a tax-exempt bond issue or are reasonably expected to become gross proceeds of a tax-exempt bond issue; (ii) amounts that formerly were gross proceeds of a tax-exempt bond issue but are no longer treated as gross proceeds of such issue as a result of the operation of the universal cap; (iii) amounts held or to be held together with gross proceeds of one or more tax-exempt bond issues in a refunding escrow, defeasance escrow, parity debt service reserve fund or commingled fund; (iv) proceeds of a taxable bond issue that refunds a tax-exempt bond issue or is refunded by a tax-exempt bond issue; and (v) other amounts that are subject to yield limitations under the Code's rules applicable to tax-exempt bonds.

D. Temporary Periods.

1. Advance refunding bond proceeds have a general temporary period of 30 days from the date of issue. Treas. Reg. § 1.148-9(d)(2).

2. Costs of issuance, accrued interest, *etc.* for an advance refunding issue have a 13-month temporary period. Treas. Reg. § 1.148-9(d)(2)(iv).

3. The initial temporary period for prior bond proceeds terminates on the issue date of an advance refunding. Treas. Reg. § 1.148-9(d)(2)(iii)(B). By contrast, in the case of a current refunding, the temporary period continues even after such proceeds become transferred proceeds until the date such temporary period would have ended without regard to the discharge of the prior issue. Treas. Reg. § 1.148-9(d)(2)(iii)(A).

4. The permitted higher yield due to a temporary period, minor portion or reasonably required reserve can be waived. Treas. Reg. § 1.148-9(g). For example, an issuer is permitted to blend yields between a project fund and an advance refunding escrow if the temporary period for the project fund is waived under this rule. The temporary period described above in D.1. is almost always waived so that yield on an escrow can be determined from the closing date.

E. Reasonably Required Reserve Fund.

1. Reserves funded from refunding bond proceeds are yield-restricted to the extent that, when combined with prior bond reserves, they exceed the least 10% of the refunding issue size and other applicable limits. Treas. Reg. § 1.148-9(e).

2. Prior bond proceeds in a reserve fund are treated under the rules for the prior bond issue. Thus, such amounts would generally remain unrestricted but would become subject to rebate at the refunding bond yield upon becoming transferred proceeds.

3. Prior bond proceeds previously on deposit in a reserve fund and transferred to the escrow fund will be restricted to the old bond yield unless and until they become transferred proceeds.

4. Although not expressly addressed in the regulations, many practitioners take the view that a reserve fund for floating rate bonds may be sized as if the bonds had been issued at a fixed rate, based on PLR 8351138.

F. Minor Portion.

1. An unrestricted investment is also allowed up to the lesser of 5% of the proceeds of the issue or $100,000.

2. A minor portion is permitted for both the refunding issue under Code Section 148(e) and the prior issue under Code Sections 148(e) or 149(d)(3)(A)(v). Treas. Reg. § 1.148-9(f). Thus, if a bond is advance refunded, the proceeds of that bond do not lose their minor portion (determined under the rule of Treas. Reg. § 1.148-9(f)).

G. Yield Reduction Payments.

1. Yield reduction payments to the U.S. Treasury, which are treated as a payment with respect to an investment that reduces the yield on that investment, are generally unavailable for advance refunding bonds. Treas. Reg. § 1.148-5(c)(3)(ii).

2. Yield reduction payments may be made with respect to a nonpurpose investment allocable to transferred proceeds of:

a. A current refunding issue to the extent necessary to reduce the yield on such transferred proceeds to satisfy the yield restriction requirements of Code Section 148(a).

b. An advance refunding issue to the extent that investment of the refunding escrows allocable to refunding proceeds (other than transferred proceeds) in zero yielding nonpurpose investments is insufficient to satisfy the yield restrictions of Code Section 148(a).

c. Nonpurpose investments allocable to proceeds of a refunding issue when SLGs are unavailable.

3. Issuers may make yield reduction payments on variable yield advance refunding issues (including with respect to the investments in the escrow funded with the proceeds of such an issue) in cases in which:

a. The issuer has entered into a qualified hedge in the form of a variable-to-fixed interest rate swap on all of the variable yield bonds that are allocable to the advance refunding escrow;

b. The hedge covers the entire period from the bond issue date to the date on which the final payment is to be made from the escrow; and

c. The yield on the escrow is restricted to a yield not greater than the yield on the advance refunding bonds, determined by taking into account the fixed payments the issuer is expected to make under the hedge and by assuming that the corresponding variable interest payments to be made by the issuer on the hedged bonds and to be received by the issuer under the hedge are equal and paid on the same date.

V. Current Refunding Rules.

A. Amount-to-Amount Rule.

1. No Volume Cap. Current refundings of private activity bonds are exempted from the need to obtain statewide private activity volume cap to the extent that the "amount" of the current refunding bonds does not exceed the "outstanding amount" of the prior bonds. Code Section 146(i)(1). Of course, this limitation does not apply to current refunding bonds for qualified 501(c)(3) bonds, qualified airports, docks and wharves,

qualified veterans' mortgage bonds, and governmentally owned solid waste facilities because they do not require volume cap allocation.

2. Measure of Principal Amount. The term "amount" has been interpreted to mean the par amount as applied to the prior bonds, and the issue price as applied to the refunding bonds.[6] One private letter ruling indicates, however, that the more appropriate valuation of the prior bond issue may be its adjusted issue price under the old regulations, particularly with respect to capital appreciation bonds or deep discount bonds.[7] Note that the "amount" of a bond issue may be different for different purposes. For example the amount for small issuer rebate exemption depends on whether premium or discount is de-minimis. Amount for Bank Qualification purposes may also be different.

3. Transition Rules. Current refunding bonds issued under the transition rules of the Tax Reform Act of 1986 (Section 1313) must generally also meet an amount to amount restriction.

B. Weighted Average Maturity Tests.

1. Private Activity Bond Requirement. As a general rule, the weighted average maturity of an issue of private activity bonds cannot exceed 120% of the weighted average useful lives of the facilities financed. Code Section 147(b). This rule applies to refundings as well as new money issues.

2. Volume Cap Requirement. For purposes of the volume cap rules, in addition to the limitation on the amount of bonds issued, the maturity date of the refunding bonds cannot be later than the later of (a) the average maturity date of the prior bonds or (b) 17 years from the date of issuance of the original new money bonds with respect to student loan bonds and 32 years with respect to qualified mortgage bonds or else a new allocation of volume cap will be required. Code Section 146(i)(2) and (3).

3. Other Replacement Proceeds. If bonds are outstanding longer than reasonably necessary for the governmental purposes of the issue, certain funds on hand of the issuer may be treated as replacement proceeds subject to the rules of Code Section 148. There is a "safe harbor" against replacement proceeds, however, if either (i) the refunding bonds meet the 120% weighted average maturity test described above, or (ii) the prior bonds met the test and the weighted average maturity of the refunding bonds does not exceed that of the prior bonds. Treas. Reg. § 1.148-1(c)(4)(B).

4. The weighted average maturity of a bond is computed by multiplying the bond's issue price (not par) by the years to maturity. The weighted average maturity of an issue will be the sum of the weighted average maturities of all of the bonds comprising the issue divided by the aggregate issue price of the issue.

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[6] *See* footnote 146, General Explanation of the Tax Reform Act of 1986.

[7] *See* PLR 9431007 (amount of private activity volume cap required for old bonds).

C. 90-Day Rule.

1. As noted above, a current refunding is defined as any refunding issue that is issued not more than 90 days prior to the final expenditure of refunding bond proceeds to pay debt service on the prior issue. Treas. Reg. § 1.150-1(d)(3)(i).

2. If the refunding issue was issued prior to 1986, the 90-day limit is expanded to (i) 180 days; or (ii) up to three years if the prior issue (and any prior refunding issues) has an aggregate term of less than three years and was issued in anticipation of permanent financing. Treas. Reg. § 1.150-l(d)(3)(ii).

D. Yield Limitations.

1. For current refunding bond proceeds, the general temporary period is 90 days. Treas. Reg. § 1.148-9(d)(2)(ii).

2. In the case of a short-term current refunding that has an original term to maturity of 270 days or less, the temporary period is 30 days, with the maximum cumulative temporary period in a series of refundings being 90 days. Treas. Reg. § 1.148-9(d)(2)(ii).

3. Transferred proceeds of a current refunding are allowed the same temporary period that they would have absent the refunding. Treas. Reg. § 1.148-9(d)(2)(iii).

VI. Allocation and Accounting Rules for Refundings.

A. General Rule. Generally, the direct tracing method must be used for sale proceeds or investment proceeds (but not replacement proceeds) of a refunding issue. Treas. Reg. § 1.148-9(c)(1)(i).

B. Operating Rule. Unlike prior Treasury regulations, the current regulations contain an operating rule for partial refundings to divide the prior issue and its proceeds into a refunded part and an unrefunded part. Treas. Reg. § 1.148-9(i). This allocation must be consistent with the multipurpose allocation rules and is based upon the percentage of the prior issue equal to: (i) the "principal" of the prior issue to be paid from proceeds of the refunding issue, divided by (ii) the "principal" of the prior issue outstanding as of the date of the refunding. See C.4.b. below.

C. Transferred Proceeds.

1. In General. As proceeds of a refunding issue are used to pay the principal of a prior bond (but not the interest), the regulations treat the refunding issue as a substitute source of the investment made with prior bond proceeds. The timing and method by which this substitution as to source occurs is governed by the "transferred proceeds" rules of Treas. Reg. § 1.148-9(b). These rules are summarized below.

2. Application of Multipurpose Rules. It must be remembered that the multipurpose issue rules are first used to subdivide both the new issue and the refunded issues

into multipurpose issues. Thus, for purposes of this discussion of transferred proceeds, the refunding issue and prior issue are only the sub-issues allocable to a particular purpose.

3. Transfer Dates. Sale proceeds, investment proceeds and "transferred proceeds" of a prior issue (but not sinking funds or replacement proceeds) cease to be proceeds of the prior issue and are allocated as proceeds of a refunding issue ("transferred proceeds" of the refunding issue) on the date or dates when proceeds of the refunding issue discharge the principal of the prior issue. Treas. Reg. § 1.148-9(b)(1). A bond is considered "discharged" when interest ceases to accrue.

4. Transfer Percentage. If only a portion of a prior issue is discharged on a given date (*e.g.,* serial bond principal is due and discharged by refunding bond proceeds prior to the call date), then only a portion of the prior bond proceeds will become transferred proceeds of the refunding issue on that date. The portion that so "transfers" is an amount equal to the proceeds of the prior issue on the transfer date(s) multiplied by a fraction equal to:

a. the "principal" of the prior issue paid on that date from proceeds of the refunding issue, divided by

b. the "principal" of the prior issue outstanding immediately prior to such discharge. Treas. Reg. § 1.148-9(b)(1). For purposes of these rules, the "principal amount" of a bond of an issue means, in reference to a plain par bond, its stated principal amount, and in reference to any other bond, its present value. Treas. Reg. § 1.148-9(b)(2).

5. Ratable Allocation Method. Proceeds of a prior issue in a "refunding escrow" must be allocated to transferred proceeds of the refunding issue based upon a ratable (pro rata or "strip") method, *i.e.,* a ratable portion of each investment. Treas. Reg. § 148-9(c)(1)(ii), (iii). A "refunding escrow" is one or more funds that are "established as part of a single transaction or a series of related transactions, containing proceeds of a refunding issue and any other amounts to provide for payment of principal or interest on one or more prior issues." Treas. Reg. § 1.148-1(b). However, two or more funds established with the proceeds of "completely" separate bond issues, or replacement proceeds deposited in an escrow more than six months prior to or after the proceeds of the refunding issue, generally will not be considered part of the same refunding escrow. Treas. Reg. § 1.148-1(b).

6. Representative Allocation Method. For other proceeds of a prior issue (*e.g.*, not in a refunding escrow), the issuer may transfer proceeds to the refunding issue based upon the ratable method or a "reasonable" representative allocation method. Unlike the ratable allocation method, the representative allocation method permits whole investments to be allocated. The determination whether a particular method is reasonable is based upon the totality of facts and circumstances. Treas. Reg. § 1.148-9(c)(1)(iii), (iv).

a. Current yields, maturities, and unrealized gains and losses on the allocated investments must be comparable to those of the aggregate investments.

b. Individual investments may be allocated to transferred proceeds if the fair market value of the specified investment is correctly proportionate to the entire fair market value of investments that could transfer.

c. The allocation of investments need not be proportional among the various funds of the prior issue, *e.g.,* construction fund, reserve fund, capitalized interest fund.

7. Multigenerational Transfers. In the case of a refunding of a prior issue that was itself a refunding, the regulations provide a specific rule regarding the yield at which proceeds of the original new money issue "cascade" to eventually become transferred proceeds of the second refunding issue. The rules provide that the proceeds of the original new money issue are treated as having a yield equal to that of the escrow of the first refunding issue when they in turn become transferred proceeds of the second refunding issue. Treas. Reg. § 1.148-9(b)(4).

8. Valuation of Transfers. All investments are valued in accordance with Treas. Reg. § 1.148-5(d). For yield-restricted proceeds transferring from a tax-exempt bond issue to a refunding issue, this means present value. Treas. Reg. § 1.148-5(d)(3). Unrestricted funds (*e.g.,* debt service reserve funds) need not be marked to market on a transfer date. Treas. Reg. § 1.148-5(d)(3)(ii). There is a special transition rule for transferred proceeds in Treas. Reg. § 1.148-5(d)(4), which states that the value of a nonpurpose investment that is allocated to transferred proceeds of a refunding issue on a transfer date may not exceed the value of that investment used for purposes of applying the arbitrage restrictions to the refunded issue.

9. Effect on Universal Cap. Proceeds of a prior issue are deemed to transfer to the refunding issue prior to any application of the universal cap. To the extent that nonpurpose investments that otherwise would transfer to the refunding issue would cause the universal cap for the refunding issue to be exceeded, then the excess amounts are immediately reallocated back to the prior issue. Treas. Reg. § 1.148-9(b)(3).

D. Universal Cap.

1. The "universal cap" rules are based upon the conceptually simple principle that there should be no more proceeds and nonpurpose investments (measured by value) allocated to a bond issue than there are outstanding bonds (also measured by value).

2. In general, nonpurpose investments with a value in excess of the universal cap are eligible to be allocated to another issue. Any amounts that are so reallocated to another issue must be treated as replacement proceeds of the other issue. Treas. Reg. § 1.148-6(b)(2)(iv)(B). If, however, amounts that would become transferred proceeds on a particular date exceed the cap, they are allocated back to the issue from which they came, apparently as replacement proceeds. Treas. Reg. § 1.148-9(b)(3)(i). The provisions of the current Treasury regulations contain substantive changes from prior Treasury regulations which were silent as to the characterization of the proceeds upon reallocation. It seems that the IRS intended that the recharacterization of the prior bond proceeds be applied on a

retroactive basis.[8] Thus, for example, a refunding in 1993 of a 1985 low-to-high refunding of 1980 new money bonds can impact the tax-exempt status of the original 1980 issue. This limitation could reduce the ability of issuers to accelerate the repayment of a refunding issue, particularly a taxable refunding issue.

3. The universal cap rules need not be applied to an issue if:

a. the issuer expects, as of the date of issue, that the universal cap rules will not reduce the amount of gross proceeds of an issue during the term of the issue; and

b. in fact:

(i) no replacement proceeds are allocated to the issue other than amounts in a bona fide debt service fund (which under these rules, do not absorb any of the universal cap) or a reasonably required reserve or replacement fund;

(ii) the net sale proceeds:

(a) qualified for one of the available temporary periods, and in fact the net sale proceeds were spent prior to the expiration of the relevant temporary periods; or

(b) were deposited in a refunding escrow and spent as originally expected;

(iii) in the case of a refunding, the prior issue will have no unspent proceeds as of any transfer date;

(iv) the bonds are retired no earlier than was originally projected in computing the bond yield; and

(v) none of the proceeds of the issue are invested in qualified single family mortgages or student loans. Treas. Reg. § 1.148-6(b)(2)(i).

4. The universal cap is generally computed and applied on the first day of the first bond year that begins two years after the date of issue and annually on the first day of each bond year thereafter. Treas. Reg. § 1.148-6(b)(2)(iii). In addition, for refunding and refunded issues, the cap must be computed on each potential transfer date under the refunding rules. Treas. Reg. § 1.148-6(b)(2)(iii).

E. One Issue Rule. The allocation of investments to a bond issue is limited by the "one issue" rule: at any given time, an investment cannot be allocated to the gross proceeds of

[8] *See* Treas. Reg. § 1.148-11(c)(1)(ii) (allowing for payments being made to the IRS to reduce yield on investments of issues to which the regulations do not otherwise apply).

more than one issue. Treas. Reg. § 1.148-6(b)(1). In the event that an investment could be treated as proceeds of one issue and replacement proceeds of another (*e.g.,* as original proceeds of a refunding issue and as replacement proceeds of the refunded issue), then they are to be allocated to the issue of which they are proceeds until they cease to be treated as proceeds of that issue by operation of (i) the allocation of such amounts to an expenditure for a governmental purpose; (ii) the transferred proceeds rules relating to refundings; or (iii) the universal cap.

F. Special Rules – Mixed Escrows.

1. Definition. A "mixed escrow" is a "refunding escrow" consisting of bond proceeds and other amounts. Treas. Reg. § 1.148-9(c)(2). A "refunding escrow" is a fund established to pay principal and interest on one or more prior issues as part of a single transaction or series of transactions. For this purpose, deposits of proceeds and non-proceeds more than six months apart are not such a series of transactions. Treas. Reg. § 1.148-1(b). Mixed escrows are subject to the requirements that the amounts other than bond proceeds must be spent at least ratably with (*i.e.,* no slower than) the bond proceeds; and that the refunding bond proceeds and non-proceeds be used to pay principal, interest and call premium ratably with reasonable adjustments for rounding during the period there are unspent proceeds of the prior issue. Treas. Reg. § 1.148-9(c)(2)(i). These limitations are intended to prevent the non-bond proceeds from being invested longer than the proceeds and to prevent the non-bond proceeds from being targeted to pay principal on the prior issue so as to avoid transferred proceeds.

2. Short Term Funds. Amounts from a bona fide debt service fund for the prior issue or held to carry out the governmental purposes of the prior issue (*e.g.,* construction fund or capitalized interest) must be allocated to the earliest maturing investments (not the earliest expenditure). Treas. Reg. § 1.148-9(c)(2)(ii)(A). An issuer may allocate amounts not subject to the mandatory allocation rules for short term funds above (*e.g.,* true "equity" of the issuer) to the earliest expenditures in the escrow, provided that such expenditures are made before any payment of principal of the prior issue is made from the refunding escrow. Treas. Reg. § 1.148-9(c)(2)(ii)(B).

G. After-Arising Replacement Amounts. The rules for "after arising replacement amounts" contained in earlier Treasury regulations have been dropped. However, the concept may have been subsumed within the "abusive arbitrage device" rules and the more general concept of replacement.

H. Multipurpose Allocation Rules.

1. Under both Treas. Reg. § 1.148-9(h)(l) and Treas. Reg. § 1.141-13(d)(l), an issuer may treat portions of a prior issue and of a refunding issue that financed two or more "separate governmental purposes" as separate issues for all arbitrage and rebate purposes other than: (i) the yield on the bond issue; (ii) the amount of rebate due; (iii) the "minor portion" available for the issue; (iv) the amount of a reasonably required reserve fund; and (v) the election to retroactively apply certain arbitrage rules to certain issues and for private activity purposes other than (vi) the private loan financing test and (vii) the acquisition of non-governmental output property.

2. "Separate governmental purposes" include: (i) the refunding of a separate prior issue; (ii) the financing of separate purpose investments; (iii) the financing of a construction issue; and (iv) any other clearly discrete governmental purpose. Treas. Reg. § 1.148-9(h)(3).

3. The separate purposes of a refunding issue include the separate purposes of the prior issue. Id.

4. Common costs, such as reserve funds and costs of issuance, are not separate governmental purposes. Id.

5. Two or more purposes with the same temporary period (*e.g.,* two construction projects) may be treated as a single purpose. Id. In addition, all integrated or functionally related capital projects with the same initial temporary period <u>generally</u> are treated as a single governmental purpose.[9] Id.

6. Subject to certain rules set forth in Treas. Reg. § 1.148-9(h)(4), the individual maturities of the prior issue may be allocated among the separate governmental purposes. Treas. Reg. § 1.148-9(h)(2)(i).

7. Similarly, the investments of the prior issue (both purpose and nonpurpose) may be allocated among the separate purposes in any reasonable and consistently applied manner. Treas. Reg. § 1.148-9(h)(2)(i).

a. An allocation under the multipurpose allocation rules may be made at any time but once made may not be changed.

b. An allocation is not reasonable if it achieves more favorable results to the issuer under the arbitrage and rebate rules (and under Code Section 149(d)) than if the issuer had actually financed the separate purposes with separate issues.

c. Certain common costs, such as reserve funds and costs of issuance, may be allocated on a non-pro rata basis if such allocation more accurately reflects the substance of the transaction. For example, escrow verification expenses may be more properly allocable to a refunding purpose. Similarly, an additional deposit to a reserve fund as part of a refunding/new money issue may be more properly allocable to the new money portion if the reserve fund for the refunded bonds were transferred to the reserve fund for the new issue. Treas. Reg. § 1.148-9(h)(2)(ii).

8. <u>Allocations of Bonds to Refunding Purposes</u>. In a multipurpose issue, each separate refunding issue's bonds must satisfy Treas. Reg. § 1.148-9(h)(1) and (h)(2) and one of the following methods: (i) a pro rata allocation; (ii) a method that reflects aggregate principal and interest payable in each bond year that is less than, equal to or proportionate to the aggregate principal and interest payable on the prior issue for that bond year; (iii) a method that results from allocation of all of the bonds of the entire multipurpose issue in

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[9]For a related, more general multipurpose rule, see Treas. Reg. § 1.150-1(c)(3).

proportion to the remaining weighted average economic life of the capital projects financed or refinanced by the issue; or (iv) another reasonable allocation method but only to the extent the above three methods are not permitted under state law, "reasonable" terms of bonds issued before (or subject to a master indenture that became effective prior to) July 1, 1993, or other similar restrictions or circumstances. Treas. Reg. § 1.148-9(h)(4)(v).

9. Interim Financing. The foregoing multipurpose allocation rules need not be applied to refinancing of interim financing (*e.g.,* bond anticipation notes or commercial paper) sold in anticipation of permanent financing, provided that the aggregate terms of all such interim financings does not exceed three years. Treas. Reg. § 1.148-9(h)(4)(vi).

10. Limitations on Multigeneration Allocations. The multipurpose issue rules only apply to an allocation of a multipurpose prior issue if that prior issue is refunded directly by an issue to which the multipurpose rules apply. Treas. Reg. § 1.148-9(h)(5). This multigeneration allocation limitation is not applicable, however, for purposes of applying certain of the advance refunding limitations. Treas. Reg. § 1.149(d)-1(d)(1). Consider the situation of a 1976 project issue followed by a 1980 multi-purpose issue, which refunds the 1976 project issue and raises new money for a 1980 project, followed by a 1986 issue for the sole purpose of advance refunding the 1980 issue. The 1986 issue was the first advance refunding of the 1980 project and the second advance refunding of the 1976 project. In 1993 an issuer wishes to do the second refunding of the 1980 new money portion. Although Treas. Reg. § 1.148-9(h)(5) prohibits treating the 1980 issue as a "multi-purpose issue" for Code Section 148 purposes, the 1986 issue can be recognized as a multipurpose issue having as its purposes the multiple purposes of the 1980 issue. Therefore the portion of the 1986 issue attributable to the first refunding purpose can be refunded a second time.

VII. Valuation of Investments.

Proper computation of the arbitrage yield (crucial in an advance refunding) and rebate due on investments requires a valuation of the investments at various points in time. Specifically, investments must be appropriately valued upon their purchase or sale and on any date that the investments become allocated to an issue or cease to be allocated to an issue by virtue of the universal cap or the transferred proceeds rules. In addition, in order to compute the rebate due on any date other than the final computation date, an appropriate interim valuation must be made. These rules with respect to the valuation of investments are largely contained in Treas. Reg. § 1.148-5(d).

A. Valuation of Investments.

1. Fair Market Value. Generally, a nonpurpose investment must be valued at its "fair market value" (discussed below) as of the date on which it becomes allocated to gross proceeds of an issue or ceases to be so allocated. Such an allocation would include: (i) the initial purchase of an investment with bond proceeds; (ii) the "transfer" of an investment from prior bonds to refunding bonds as transferred proceeds; (iii) the sale of any investment allocated to the bond proceeds; (iv) the "sale" of a previously acquired investment from an account of the issuer to a bond-related account; and (v) the deposit or pledge of

previously acquired investments to a reserve fund or sinking fund. Treas. Reg. § 1.148-5(d)(3)(i).

2. Present Value. The fair market valuation need not apply to the extent that an investment transfers from a prior issue to a refunding issue or becomes allocated or ceases to be allocated to an issue as a result of the universal cap, provided that the issue from which the investment transfers consists of tax-exempt obligations. Treas. Reg. § 1.148-5(d)(3)(ii).

3. Yield Restricted Investments. Yield restricted investments must be valued at their present value on any interim valuation date. Treas. Reg. § 1.148-5(d)(2). The present value of the investment is computed using its original yield (based upon the same compounding method as that on the bond issue) as the discount rate. Treas. Reg. § 1.148-5(d)(5).

4. Other Investments. Any other investment may be valued on any interim valuation date based upon: (i) its fair market value; (ii) its present value; or (iii) its par value plus accrued interest in the case of "plain par investments." Treas. Reg. § 1.148-5(d)(1).

5. Commingled funds. For certain commingled funds, certain mandatory "mark to market" rules will apply.

B. Fair Market Value.

1. In General. The fair market value for an investment is defined generally as the price a willing buyer would pay a willing seller in a bona fide arm's-length transaction. Treas. Reg. § 1.148-5(d)(6)(i). References to the "mean bid-ask" Treasury price and to the estate and gift tax regulations have been eliminated from the current Treasury regulations.

2. Presumption. For investments that are not traded on an established securities market, there is a rebuttable presumption that the price paid is not fair market value. Treas. Reg. § 1.148-5(d)(6)(i).

3. SLGs. The fair market value of a SLGs obligation or other obligation purchased directly from the Treasury is the obligation's purchase price. Treas. Reg. § 1.148-5(d)(6)(i).

4. Fair Market Value Regulations. On December 30, 1998, the Treasury and IRS published final regulations (the "FMV Regulations") providing a safe harbor for establishing the fair market value of (a) guaranteed investment contracts, and (b) any investments purchased for yield restricted defeasance escrows, including both refunding and sinking fund escrows. The FMV Regulations amended the existing bidding rules for guaranteed investment contracts and added new bidding rules for yield restricted escrow investments.

5. Fair Market Valuation of Forward Float Contracts. On August 30, 2007, the IRS issued a press release (IR-2007-152) announcing a special, limited-duration voluntary closing agreement program to cure non-fair market value dispositions of forward float rights arising in advance refunding escrows. The program focused on negotiated, stand-alone forward float contracts that were not bid under the safe harbor provisions of Treasury Regulations Section 1.148-5(d)(6)(iii), and "resolution terms" of the VCAP program were only available until March 1, 2008. Under the VCAP approach, a forward float contract would be treated as being acquired at fair market value if it provided for an upfront payment to the issuer equal to at least 80 percent of the theoretical upfront payment derived using the "Forward Treasury Model" and associated methodology described in the announcement. If an issuer determined that the payment it received for a negotiated forward float contract did not meet the 80 percent threshold, it could effectuate a cure by paying the IRS a settlement amount equal to the amount necessary to reduce the aggregate yield on the escrow to the bond yield, taking into account the Forward Treasury Model-derived fair market value of the forward float contract.

C. Reasonable Administrative Costs Taken into Account.

1. In General. Reasonable, direct administrative costs of investments can be taken into account as "qualified administrative costs" (reducing receipts or increasing payments; thereby reducing the yield). Treas. Reg. § 1.148-5(e)(2).

2. Comparability. The strongest evidence of the reasonableness of such a fee is whether it is the same as would have been charged if the investment were acquired with non-bond proceeds. Treas. Reg. § 1.148-5(e)(2)(i).

3. Direct Costs Only. The costs must be the direct administrative costs related to the investments; overhead and general administrative costs, such as carrying costs, legal and accounting fees, recordkeeping, and custody costs, do not qualify. Treas. Reg. § 1.148-5(e)(2)(i).

4. RICs and Commingled Funds. Special rules apply to the expenses of any publicly offered regulated investment company and any widely held commingled fund in which the issuer and any related parties do not own more than 10% of the beneficial interest in the fund. Treas. Reg. § 1.148-5(e)(2)(ii).

5. Broker fees for GICs and Yield Restricted Escrow Investments. There are also special rules that apply to broker fees for guaranteed investment contracts ("GICs") and investments purchased for a yield restricted defeasance escrow ("Yield Restricted Escrow Investments"). Such fees may be treated as qualified administrative costs to the extent such fees are reasonable. A fee is treated as reasonable under the December 2003 final regulations (the "Final Broker Fee Regulations") to the extent that such fee does not exceed the lesser of $30,000 and 0.2% of the "computational base" or, if more, $3,000, and, for any bond issue, the issuer does not treat as qualified administrative costs more than $85,000 in broker fees or similar fees with respect to all GICs and Yield Restricted Escrow Investments purchased with gross proceeds of such bond issue. The Final Broker Fee Regulations provide for a cost-of-living adjustment that allows for the increase of both the $30,000 and $85,000 limits in

calendar years after 2004. The Final Broker Fee Regulations define the "computational base" for GICs to be the amount of gross proceeds the issuer reasonably expects, as of the date the GIC is acquired, to be deposited in the GIC over its term, and for Yield Restricted Escrow Investments to be the amount of gross proceeds initially invested in such investments. The former five-basis-point test for GICs, which took into account the duration in determining the maximum fee, and the former $10,000/10-basis-point test for Yield Restricted Escrow Investments were superseded by the Final Broker Fee Regulations.

D. Definition of "Investment-Type Property."

1. In General. Investment-type property is defined as "any property . . . held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money, including the benefit from making a prepayment."

2. Prepayments. Prepayments are deemed to give rise to "investment-type property" when "a principal purpose" of prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made.

3. Hedges with Significant Investment Elements. A bond hedging transaction that would otherwise be a qualified hedge for purposes of computing yield on the bond issue is treated as investment-type property to the extent that it contains a "significant investment element," because a payment by the issuer relates to a conditional or unconditional obligation by the hedge provider to make a payment on a later date. The 1997 Final Regulations treat (i) an interest rate swap requiring any payments other than periodic payments (*e.g.,* a payment for an off-market swap or prepayment of part or all of one leg of a swap) and (ii) an interest rate cap requiring the issuer's premium to be paid in a single up-front payment as contracts with significant investment elements.

E. Hedges of Investments. The Treasury regulations do not provide specific rules for treatment of hedges of assets allocable to proceeds of tax-exempt bonds, but the IRS has requested comments on the proper treatment. Moreover the purchase of a hedge in the form of a commodities or futures option is not addressed.

F. Yield-Burning Payment Procedure. In Rev. Proc. 96-41, 1996-2 C.B. 301, the IRS provided a procedure by which issuers generally could enter into voluntary closing agreements to make payments to the IRS to preserve the tax-exempt status of advance refunding bonds in circumstances involving payment of above-market prices for open-market Treasury securities. In general, the measure of the payment to the IRS under this revenue procedure is based on the excess of the actual price paid for the investments over the next-day delivery "spot price" for the investment, plus interest to the date of the payment at the bond yield. Rev. Proc. 96-41 originally had a payment deadline date of July 19, 1997. In Notice 96-49, 1996-2 CB 215, the IRS extended that deadline date to a date "no earlier than one year from the date the IRS publishes further guidance relating to the duration of the closing agreement program." On January 15, 1997, the IRS held a public hearing on these revenue procedures. No further guidance has been published with respect to either of these revenue procedures.

VIII. Refundings vs. Reimbursement Allocations.

A. Refundings.

1. Generally, no reimbursement allocation is permitted if the expenditure to be reimbursed was paid from the proceeds of another obligation. Instead, such an allocation is analyzed under the refunding rules.[10]

2. The proceeds of an issue that was issued for reimbursement purposes and is subsequently refunded will be treated as being unspent for transferred proceeds purposes unless the reimbursement qualified under the law applicable to the prior issue. This is true even if the prior bonds were taxable.

B. Anti-Abuse Limitations. The regulations create a one-year "step transaction" rule to the extent that amounts "corresponding" to a reimbursement are used to defease or refund other bonds, treating the purported reimbursement as a refunding. The term "corresponding" is not defined. An exception is provided where the reimbursement amounts are spent on current debt service within one year. Any reimbursement allocation that employs an "abusive device" is not a qualified reimbursement. Treas. Reg. § 1.150-2(h).

C. Scope of Reimbursement Rules. The reimbursement rules apply to governmental issues and private activity bonds, including qualified 501(c)(3) issues.

IX. Refunding vs. Acquisition.

A. In General. An issue is not a refunding issue if the obligor of the prior issue is neither the obligor of the refunding issue nor a related party to such obligor (the "Change in Obligor Exception"). This "change in obligor" concept has the effect of distinguishing between an acquisition-defeasance and refunding. In an acquisition-defeasance, the proceeds are allocated and deemed spent by the new obligor to acquire the facilities from the old obligor and the old obligor is deemed to have created an invested sinking fund with the sales proceeds. The relevant yield restriction in an acquisition-defeasance is the prior issue yield. If a person assumes (or takes subject to) the obligations of an unrelated party in connection with an asset acquisition and such assumed obligation is refinanced within six months before or after the assumption, the refinancing of such debt is not treated as a refunding (the "Six-Month Exception"). If a refinancing occurs outside this 12-month window, however, the issue would be characterized as a refunding.

B. Conduit Financings. A conduit financing issue is an issue the proceeds of which are used to make a conduit loan (*i.e.,* the purpose investment) to a conduit borrower. In a conduit

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[10]Treas. Reg. § 1.150-2(g)(1). In PLR 9644019, involving the distinction between refundings and reimbursements, the IRS found that an interest-bearing inter-fund borrowing between two related parties should not be analyzed as a refunding due to the control relationship between the lender and the borrower, and thus was eligible for financing under a reimbursement analysis.

financing, the conduit borrower is the obligor, except for single family mortgage loan bonds and student loan bonds or similar program investments, in which the actual issuer is the obligor.

1. For purpose investments, the use of proceeds of an issue that is used to refund an obligation that is a purpose investment (a conduit refunding issue) by the actual issuer of the conduit financing issue determines whether the conduit refunding issue is a refunding of the conduit financing issue (in addition to a refunding of the obligation that is the purpose investment). Treas. Reg. § 1.150-1(d)(2)(iii)(A).

2. If the actual issuer of the conduit financing issue reasonably expects as of the date of receipt of funds from the proceeds of the conduit refunding issue to use those amounts within six months to make a new loan (that is, to recycle the proceeds to acquire a new purpose obligation), the transaction is not treated as a refunding of the conduit financing issue. Treas. Reg. § 1.150-1(d)(2)(iii)(B).

3. For this refunding rule, purpose investments that are tax-exempt obligations are treated as purpose investments. Treas. Reg. § 1.150-1(d)(2)(iii)(C).

C. Related Parties. If the old obligor and the new obligor are "related parties," the transaction is treated as a refunding. For governmental entities and 501(c)(3) organizations, parties are related if they are part of the same "controlled group." Treas. Reg. § 1.150-1(d)(2)(v).

D. Controlled Group; Definition of Control.

1. In General. The determination of control is made on the basis of all relevant facts and circumstances. The regulations provide that there is control if (a) one entity has the power both to approve and remove without cause the governing body of the other entity, or (b) one entity has the power to require the use of funds or assets of the other entity for the purpose of the controlling entity.[11]

2. Political Subdivision Exception. A general purpose governmental entity with substantial taxing power, eminent domain power, and police powers is not a controlled entity. Treas. Reg. § 1.150-1(e)(3). Note the entity must possess all three powers. This differs from the rules defining a "political subdivision" in which an issuer need not have all three powers.

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[11]Treas. Reg. § 1.150-1(e)(3). See PLR 200404024, in which the IRS held that an issuer established by two existing joint exercise of power agencies would not be considered to be related to either of such two agencies based on the issuer's board composition and the fact that a significant percentage of such board was required for any "substantial action" of the issuer, which included the transfer of assets and the amendment of the issuer's budget. Thus board members of either of the two original agencies that served on the issuer's board would not be sufficient in number to vote to cause the issuer to take substantial action.

3. Conduit Borrower/Lender. For Code Section 149(d)(3) purposes, however, a conduit borrower and conduit lender are treated as "related parties" even if they are not part of the same controlled group.

E. Effect. Since the "change in obligor" concept in the definition applies for all purposes of the 1986 Code, certain private activity bond work-outs that had previously been characterized as refundings may now be deemed to be acquisitions and therefore not entitled to more favorable "refunding" treatment under Code Sections 141-147. A change in obligor may also have the effect of breaking the multi-advance refunding chain for purposes of Code Section 149(d).

F. Abuses. Note that if a change in obligor occurs without a primary non-arbitrage governmental purpose, the transaction may be an abusive arbitrage device under Treas. Reg. § 1.148-10.

G. Proposed Regulations. Proposed regulations were published on April 10, 2002 regarding the definition of the term "refunding" under Treas. Reg. § 1.150-1(d). The proposed regulations are meant to resolve ambiguities in existing rules as to the circumstances in which tax-exempt bonds that are refinanced in connection with an affiliation could be treated as an "acquisition" transaction, particularly as to the level of influence or control that the selling party may have over the acquiring party in connection with both the Change in Obligor Exception and the Six-Month Exception. These proposed regulations are of particular relevance to 501(c)(3) hospital systems that have engaged in affiliation agreements involving refinancing of tax-exempt bonds, or are contemplating such arrangements. The proposed regulations clarify that the determination whether persons are related for purposes of both the Change in Obligor Exception and the Six-Month Exception is generally made immediately before the issuance of the refinancing issue.

With respect to the Six-Month Exception, the proposed regulations limit the application of the exception to situations in which a person assumes obligations of an unrelated party in connection with an "acquisition transaction," which is defined as a transaction in which a person acquires the following from an unrelated party: (i) assets (other than an equity interest in an entity); (ii) stock of a corporation with respect to which a valid election under Code Section 338 is made (*i.e.,* to treat the transaction as a purchase of the assets of the acquired entity without formally liquidating the acquired entity); or (iii) control of a governmental unit or a 501(c)(3) organization through the acquisition of stock, membership interest or otherwise.

Even if the acquiring person and the acquired person are not related parties, the proposed regulations provide that the Change in Obligor Exception and the Six Month Exception will not apply to any issue that is issued in connection with a transaction between "affiliated persons," *i.e.,* the issue will not be treated as an "acquisition," unless (x) the refinanced issue is redeemed on the earliest date on which it may be redeemed (or otherwise within 90 days of the issuance of the refinancing issue), and (y) the refinancing issue is treated for all purposes of Code Sections 103 and 141 through 150 as financing the assets that were financed by the refinanced issue. The acquired person and the acquiring person are deemed to be "affiliated persons" if (a) at any time during the six-month period *before* the transaction, more than five percent of the voting power of the governing board of either person is vested in the other person, its directors, officers, owners

or employees, or (b) during the one year period beginning six months prior to the transaction, the composition of the governing body of the acquiring person (or any person that controls the acquiring person) is modified or established to reflect (directly or indirectly) representation of the interests of the acquired person or the person from whom assets are acquired, or, during such period, the parties enter into a memorandum of understanding or other arrangement providing for such representation. The proposed regulations raise questions as to the manner in which the refinancing issue must be treated as "financing the assets that were financed with the refinanced issue," *e.g.,* application of the 120% limit on the weighted average maturity of the refinancing issue and the application of the $150 million limitation on the amount of nonhospital bonds that may benefit a 501(c)(3) organization or any organizations that are related to such organization or under common management and control with such organization.

X. Anti-Abuse Rules.

A. Broad Definition. Employment of an abusive arbitrage device makes the related bond issue taxable as arbitrage bonds. The regulations contain a broad definition of "abusive arbitrage device," analogous to the old "artifice or device" rule of Treas. Reg. § 1.103-13(j) (1979). An abusive arbitrage device is any action not expressly permitted by Code Section 148 that both: (i) enables the issuer to exploit the difference between taxable and tax-exempt interest rates to obtain a material financial advantage; and (ii) overburdens the market. Treas. Reg. § 1.148-10(a)(1) and (2).

B. Actions Taken After Issuance. An action may be deemed to exploit tax-exempt rates at any time even if, in the aggregate, the bond proceeds over time are not invested at a yield that is materially higher than the yield on the bonds. Treas. Reg. § 1.148-10(a)(3). This is different from the old artifice or device rules of Treas. Reg. § 1.103-13(j) (1979), which required that the actions be taken at the time of initial issuance of the bond issue. This rule seems to require that an analysis be made of the marginal level of additional yield that would result from the action taken. This could affect, for example, the refunding of noncallable or low coupon bonds. The regulations provide various examples.

C. Overburdening of Market Defined. An action may overburden the tax-exempt market if it results in more bonds being issued, issuing bonds earlier, or allowing bonds to remain outstanding longer than is necessary to accomplish the governmental purposes of the issue. Specific factors to be considered include: (i) whether the action would be taken to accomplish the governmental purposes of the issue if the interest on an issue were not excludable from gross income under Code Section 103(a) (assuming the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate); (ii) issuance of a bond issue the proceeds of which are reasonably expected to exceed the amount required for the governmental purposes of the issue by more than a minor portion; (iii) the proceeds of the issue are in fact substantially in excess of the amount necessary to finance the governmental purposes of the issue; (iv) the proceeds of the issue do not qualify for one of the initial temporary periods; and (v) the term of the issue exceeds the safe harbors against the creation of replacement proceeds. Treas. Reg. § 1.148-10(a)(4).

D. Penalties for Overburdening the Market.

1. Any bond issue that overburdens the tax-exempt market (even if it does not exploit the difference between taxable and tax-exempt interest rates) is subject to further limitations: (i) the materially higher yield limit on all classes of investments is reduced to 0.001%; (ii) each investment is treated as being in a separate class and cannot be blended with other investments for yield purposes; (iii) no payments may be made to the IRS to reduce the yield on investments; (iv) no administrative costs may be taken into account in computing the yield on investments; and (v) bond proceeds are deemed to be spent last and the definition of "available amounts" does not exclude a working capital reserve.

2. These limitations apply only to the portion of the issue that overburdens the market unless the issue was expected at the time of issue to overburden the market, in which event the entire issue is subject to these limitations. Treas. Reg. § 1.148-(10)(b).

E. IRS Authority. In connection with actions taken to exploit the difference between tax-exempt and taxable rates, the Commissioner is granted wide discretion, notwithstanding any specific provisions contained in Treas. Reg. § 1.148-1 through § 1.148-11, to (i) recompute the yield on an issue or on investments, (ii) reallocate payments and receipts on investments, (iii) recompute the rebate amount on an issue, (iv) require a special rebate computation date, (v) treat a hedge as either a qualified hedge or not a qualified hedge or (vi) otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue in order to clearly reflect the economic substance of the transaction. Treas. Reg. § 1.148-10(e) and (f).

F. Refunding Examples. The regulations provide several relatively specific examples:

1. "Grey box" transactions. Treas. Reg. § 1.148-10(d) Ex. 1.

2. Refundings with a longer term than necessary, together with a sinking fund to make up negative arbitrage on the escrow. Treas. Reg. § 1.148-10(d) Ex. 2(i).

3. Refundings of noncallable bonds to recover negative arbitrage. Treas. Reg. § 1.148-10(d) Ex. 2(ii).

4. Sale of tax-exempt purpose investments financed by proceeds of a tax-exempt issue and investing the sale proceeds at an arbitrage rate to repay an issue. Treas. Reg. § 1.148-10(d) Ex. 4.

5. Escrow portfolio substitutions. Treas. Reg. § 1.148-10(d) Ex. 5.

6. Window refundings to avoid transferred proceeds. Treas. Reg. § 1.148-10(d) Ex. 3. The example further indicates that a window refunding is abusive whether or not the issuer enters into an investment agreement, whether or not the transaction is to avoid transferred proceeds or to make high yield investments, and whether the bond issue is technically a refunding or a new money issue.

G. Hedge Bond Rules. Code Section 149(g)(3)(C) generally provides that a refunding bond meets the hedge bond requirements only if the original bond meets those requirements. The regulations state that a refunding bond is a hedge bond unless there is a significant governmental purpose for the issuance, other than to create a hedge against rising interest rates. Treas. Reg. § 1.149(g)-1(c)(2).

H. Excess Gross Proceeds Rules.

1. 1% Test. Excess gross proceeds of an advance refunding issue cannot exceed 1% of sale proceeds of the issue. Treas. Reg. § 1.148-10(c)(1).

2. Definition of Excess Gross Proceeds. Excess gross proceeds are all gross proceeds of an advance refunding other than those allocable to: (i) payment of principal, interest or call premium on the prior issue; (ii) payment of pre-issuance accrued interest and interest that accrues up to the project completion date plus one year; (iii) a reasonably required reserve for the refunding issue or investment proceeds thereof; (iv) costs of issuance of the refunding; (v) administrative costs of the refunding; (vi) transferred proceeds that will be used or maintained for the purpose of the prior issue; (vii) interest on purpose investments, (viii) replacement proceeds in a sinking fund for the refunding issue; (ix) qualified guarantee fees for the refunding or prior issue or (x) fees for a qualified hedge for the refunding issue. Treas. Reg. § 1.148-10(c)(2).

XI. Replacement.

A. Introduction. The concept of replacement, currently set forth in Code Section 148(a)(2), has been in the arbitrage statute since its enactment in 1969. Over the years, the concept of replacement has been gradually defined and refined, borrowing heavily from such areas of the tax law as Code Section 265 (concerning the denial of an interest expense deduction for borrowings incurred or continued to purchase or carry tax-exempt obligations). The first elaboration upon the replacement concept was the "indirect proceeds" provisions, contained in Prop. Treas. Reg. § 1.103-13(b)(2)(iii) (1973). The scope of replacement was expanded in 1978 when proposed regulations subjected amounts held in a pledged or sinking fund to yield restriction and introduced the "artifice or device" concept. *See* Treas. Reg. § 1.103-13(g) and

-13(j)(1979). In addition, numerous revenue rulings and private letter rulings have elaborated upon the concept of replacement.[12]

B. Replacement Proceeds Defined. Replacement proceeds are amounts that are not bond proceeds in the ordinary sense (*i.e.,* not sale proceeds, investment proceeds or transferred proceeds) but are treated as a special kind of bond proceeds because they would have been used for the purpose for which the bond proceeds were in fact used or could now be used to retire the bonds. Typical replacement proceeds are revenues in an invested sinking fund or amounts that are pledged to the payment of an issue either directly or through a pledge to a credit enhancer. The current Treasury regulations provide a more integrated approach to the replacement concept, giving specific definitions of replacement proceeds including those described below:

1. Sinking Funds. Amounts held in a fund that are reasonably expected to be used for the payment of debt service on a bond issue are treated as replacement proceeds of an issue. Treas. Reg. § 1.148-1(c)(1).

2. Pledged Funds. Amounts pledged to the payment of a bond issue by a "substantial beneficiary" of the issue in such a manner that they would be expected to be available in the event of financial difficulties of the issuer/conduit borrower are treated as replacement proceeds. A substantial beneficiary of an issue includes, but is not limited to, the issuer, any related party to the issuer, a principal user of the facilities financed, and the state in which the issuer is located. A qualified third party guarantor is not a substantial beneficiary of an issue. Treas. Reg. § 1.148-1(c)(1). A seller of bond financed facilities may be a substantial beneficiary.

3. Negative Pledge. An agreement to maintain an amount at a particular level for the benefit of bondholders or guarantors, but without a pledge to anyone, generally will be treated as the creation of replacement proceeds. Replacement proceeds will not be created, however, if certain conditions are satisfied. Treas. Reg. § 1.148-1(c)(3)(ii).

4. Bonds Outstanding Longer Than Necessary. If (i) bonds are reasonably expected as of their issue date to be outstanding longer than is reasonably necessary to accomplish the governmental purposes of the issue and (ii) there will be "available amounts" to invest "at the beginning of any year" during the period that the issue remains outstanding longer than necessary, then those amounts can be deemed to be replacement proceeds. Treas. Reg. § 1.148-1(c)(4)(i)(A). (These are often referred to as "other replacement proceeds" or "ORPs".) The test as to the availability of amounts at the beginning of each year during which the bonds have been left outstanding longer than is necessary leaves unclear the status of amounts that arise during the bond year but are spent prior to the end of the year. The determination whether bonds are outstanding longer than necessary is made under the anti-abuse rules of Treas. Reg. § 1.148-10. Nonexclusive safe harbors from this broad rule are provided in the refunding context for:

[12]See, *e.g.,* Rev. Rul. 78-302, 1978-2 C.B. 94; Rev. Rul. 82-101, 1982-1 C.B. 21. *See also* Peaslee, *The Limits of Section 103(c): Municipal Bond Arbitrage After the Invested Sinking Fund,* 34 Tax L. Rev. 421 (1979).

a. Working Capital. The portion of an issue used to finance working capital, if such portion is not outstanding longer than two years.

b. Economic Life. In the case of bonds issued to finance (or refinance) a capital project, if the issue has a weighted average maturity equal to no more than 120% of the weighted average reasonably expected economic life of the financed project.

c. Refundings. For the portion of an issue that is a refunding issue, if that portion has a weighted average maturity that does not exceed the remaining weighted average maturity of the prior issue, and the issue of which the prior issue is a part satisfied either the working capital or economic life safe harbor set forth above.

5. Working Capital Replacement. Replacement also arises whenever working capital is directly or indirectly financed. Treas. Reg. § 1.148-1(c)(4)(ii).

6. Other Amounts Having Nexus. Replacement proceeds include amounts that were to be used as a source of financing for a particular governmental purpose but which as a result of the issuance of bonds will be used for another purpose. The mere availability or the preliminary earmarking of amounts for a governmental purpose, however, does not by itself establish a sufficient "nexus" to the bond issue to result in replacement proceeds. Treas. Reg. § 1.148-1(c)(1).

XII. Application of Private Activity Rules to Refunding Bonds.

Treas. Reg. § 1.141-13 provides guidance regarding the application of the private activity rules to refunding bonds.

A. Combined Measurement Period. Generally, Treas. Reg. § 1.141-13(b)(2) provides for a combined measurement period beginning on the first date of the measurement period for the prior issue (or in the case of a series of refundings the first issue of governmental bonds) and ends on the last day of the measurement period of the refunding issue. This combined measurement period generally applies to both the private use and private payment or security tests. Separate measurement periods apply when one of the issues is intentionally taxable or when it doesn't matter.

B. Multi-Purpose Rules. Under Treas. Reg. § 1.141-13(d) a bond issue may be divided up into portions used for different purposes. Refundings of one of these portions need not be concerned with the other portions. It is a bit unclear in the regulations whether separate portion treatment is mandatory. Generally, most people seem to have concluded that it is optional. For issues including refunding portions, bonds must be allocated to portions following the rules of Treas. Reg. § 1.148-9(h).

XIII. Alternatives to Advance Refundings.

A. Forward Bond Sale. The most basic transaction is a forward bond sale in which an investment banker agrees today to purchase fixed rate current refunding bonds on or shortly before the call date. The parties agree today on all the terms of the bonds.

B. Forward Swap. A similar alternative to the forward bond sale is the forward interest rate swap. This structure involves the issuer currently contracting for a swap, from floating to fixed, which does not actually take effect until or shortly before the call date of the refunded bond. At that time, the issuer issues a floating rate current refunding issue and, simultaneously, the swap takes effect to convert the floater to a fixed rate issue.

C. Option. In another structure the issuer writes 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 prior issue. The new bonds, when and if issued, will be used to currently refund the prior bonds. The amount of the up-front payment is a function of the interest rate fixed for the new issue and the length of the options.

D. Call Waivers. Investment bankers have also proposed various "call waiver" strategies. In a classic advance refunding, issuers sometimes capitalize the savings by selling additional bonds in the window created by the lower debt service on the refunding issue. 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. For arbitrage purposes, a payment in consideration for a call waiver causes a recomputation of yield as if the bond were reissued. Treas. Reg. § 1.148-4(b).

E. Purchase and Early Cancellation of Bonds. Issues can negotiate a purchase of outstanding bonds and use current refunding bonds to pay the purchase price even if not currently callable.

F. Cinderella Bonds. Sometimes an issuer wants to get the advantages of defeasance of the prior bonds. It wants to advance refund those prior bonds. However, if a tax-exempt advance refunding is not possible, it may be forced to use a taxable advance refunding. On retirement of the prior bonds (or 90 days before), the taxable advance refunding bonds may become eligible to be currently refunded on a tax-exempt basis. Because this is predictable, it is often possible to structure a taxable bond issue that can be "reissued" as tax-exempt on the appropriate date. Note that there is no such thing as a single debt instrument that can under the tax law "become tax-exempt." However, one can get close. This issuer is given certain options it can exercise on the appropriate date. If exercised, these options are designed to create a reissuance under Treas. Reg. § 1.1001-3. This is somewhat counter-intuitive since normally issuers avoid reissuance. For example, the change requires a modification and therefore cannot be automatic. Furthermore, it cannot be a unilateral option on the part of the issuer. The issuer must be given the option, but exercise of that option must trigger rights in the bond owner that prevent unilateral option treatment. Finally, the interest payment should preferably not create a taxable OID instrument. To avoid such treatment, any scheduled "step up" in the taxable interest rate must not be expected to ever apply.

In response to pressure on volume cap in certain states, a "Cinderella bond" structure has been developed. Under this structure, bonds are issued as taxable bonds with a tender right that can be exercised by the issuer at the direction of the company if the project receives volume cap. Upon mandatory tender, the bonds are purchased and canceled. A new bond is issued on the tax-

exempt conversion date bearing designation as a new series. At the closing of the taxable bonds, the company must agree to the same covenants as if the bonds were tax-exempt. A public hearing is held as well as approval received by the applicable elected official prior to issuance of the taxable bond. On the tax-exempt conversion date, a new arbitrage certificate is executed and IRS Form 8038 is filed. The tax-exempt bonds cannot be issued later than one year after the public hearing; therefore it may be necessary to have a second public hearing. In addition, the issuance of the tax-exempt bonds must meet the reimbursement rules (i.e., the tax-exempt bonds must be issued not later than 18 months after the facility financed is placed in service or three years after the original expenditure).

G. Split Closing Refundings. Often an issuer wants to refund a prior issue that can be called for redemption soon, but in more than 90 days. Bond closing can be delayed for the bonds in order to create a current refunding. When this is part of a larger transaction, the issuer may not want to wait for new money or other refunding purposes. It may then issue one new multipurpose issue with two separate closing dates. Care must however be used in meeting the requirements of Treas. Reg. § 1.148-9(h) when allocating the "current refunding bonds" to the bonds with the second closing date.

XIV. **Bank Qualification**.

There are three refunding rules relating to bank qualification.

Code Section 265(b)(3)(C) provides that current refunding bonds do not count against the small issuer status of an issuer.

Section 265(b)(3)(D) provides that current refundings of bank qualified bonds not extending the average maturity of the refunded bonds are "deemed designated" and are bank qualified even if such refunding bonds are issued in a year in which the issuer is not a qualified small issuer. One question that develops is how to measure the average maturity of the refunding bonds. Although no regulations directly apply, when allocating a part of a new issue of bonds to the refunding of prior bank qualified bonds, it makes sense to apply Treas. Reg. § 1.148-(9)(h). Therefore to meet the requirement that the average maturity not be extended, either the entire new issuer's average maturity should be compared to the average maturity of the refunded bonds, or a refunding portion meeting the rules of § 1.148-9(h) must be used.

No bond can be bank qualified if it is part of an issue including refunding bonds and such issue exceeds $10,000,000. While the reference to "such issue" is unclear, the better interpretation is that the entire new multipurpose issue may not be over $10,000,000.

PART B – REISSUANCE UNDER TREAS. REG. § 1.1001-3, NOTICES 88-130, 2008-41, 2008-88 AND 2010-7 AND ANN. 2011-19

I. **Overview**.

Changes to the terms of debt obligations, including tax-exempt bonds, may be triggered by a variety of circumstances, such as the deterioration of the financial condition of the issuer/borrower, a disposition of the bond financed facility and assumption of the debt by the

transferee, and changes to the bond terms in lieu of the issuance of refunding bonds. Any changes to the term of the bonds must be carefully scrutinized to determine if the changes cause the bonds to be "reissued" for all federal income tax purposes (including gain or loss to the bondholder) or "reissued" solely for tax exempt bond purposes under Code Sections 103 and 141-150 ("TEB Reissuance"). One important distinction between the Reissuance Regulations (defined below) on the one hand and Notices 88-130, 2008-41 and 2008-88, on the other, is that the Reissuance Regulations apply for all purposes of the Code. For example, a reissuance under the Reissuance Regulations may result in taxable gain or loss to the bondholder. Another distinction is that the Reissuance Regulations explicitly permit resetting the interest rates for reset bonds such as auction-rate bonds or other tax-exempt bonds for which the rate is reset without the holder having a "tender right." If bonds are reissued, the practitioner may need to address a variety of tax issues, described in Section IV of Part B.

A. Treas. Reg. § 1.1001-3. Treas. Reg. § 1.1001-3 (the "Reissuance Regulations") address when a modification of the terms of a debt instrument is sufficiently significant that it constitutes a deemed exchange of an old debt for a new debt, or a "reissuance," for all federal income tax purposes under Code Section 1001. Those rules broadly affect debt and are especially important for tax-exempt bonds because, absent a broad current refunding exception, reissuance of tax-exempt bonds may trigger the application of subsequent, often more restrictive, changes in law and tax-exempt bond eligibility requirements. The Reissuance Regulations provide clarity in some areas. In part, the Reissuance Regulations represent an effort to respond to the uncertainty and disarray created by a perceived "hair trigger" reissuance test suggested in the Supreme Court's 1991 decision in *Cottage Savings Ass'n. v. Commissioner,* 499 U.S. 554 (1991).

B. Notice 2008-41, as Amended and Supplemented by Notice 2008-88 and as Modified by Notice 2010-7 (TEB Reissuance).

The IRS issued Notice 2008-41, 2008-15 I.R.B. 742 ("Notice 2008-41"), to modify and clarify the determination of when tax-exempt bonds are treated as reissued and retired solely for purposes of Code Sections 103 and 141–150. Notice 2008-41, effective as of March 25, 2008, clarifies, amends, supplements and supersedes Notice 2008-27, 2008-10 I.R.B. 543, which was retroactively effective from November 1, 2007 through March 25, 2008; however, Notice 2008-41 does not supersede or replace Notice 88-130 (described below). Notice 2008-41 was subsequently amended and supplemented by Notice 2008-88, 2008-42 I.R.B. 933 and was modified by Notice 2010-7, 2010-3 I.R.B. 296. An issuer can apparently choose between the rules under Notices 2008-41, 2008-88 and 2010-7, on the one hand, and Notice 88-130, on the other hand, because the notices provide somewhat different rules. Notices 2008-41, 2008-88 and 2010-7 provide issuers with considerably more flexibility than Notice 88-130 to restructure bond issues to address the problems resulting from downgrades in municipal bond insurer ratings and failed remarketings and auctions without causing a reissuance. See Section II, below for discussion of Notices 2008-41, 2008-88, 2010-7 and Ann. 2011-19.

C. Notice 88-130 for Qualified Tender Bonds.

Treas. Reg. § 1.1001-3(a)(2) provides that the Reissuance Regulations do not apply for purposes of determining whether tax-exempt bonds that are "qualified tender bonds" under

Notice 88-130, 1988-2 C.B. 543, are reissued for purposes of Code Sections 103 and 141–150. Those special rules protect many changes in short-term interest rate modes and tender option periods in variable rate demand bond financings from being treated as a reissuance. Because Notice 88-130 also applies the general reissuance standards under Code Section 1001 in certain circumstances, there has been some ambiguity about the coordination between those provisions. Still, it seems reasonably clear that the intent was to protect qualified tender bonds that satisfy Notice 88-130 from being treated as reissued as a result of changes in interest rates either pursuant to "qualified tender changes" (*i.e.,* changes in interest rate modes pursuant to the terms of the bonds) or based on their tender periods (*e.g.,* weekly floaters) pursuant to the terms of the bonds, and to subject other changes in such bonds to the Reissuance Regulations. Notice 88-130 does, however, provide a "hair trigger" for qualified tender bonds that generally triggers a reissuance where changes are made in connection with a conversion from a long period (greater than 1 year) to a short period (less than 1 year) or vice versa.

II. TEB Reissuance Under Notices 2008-41, 2008-88 and 2010-7 and Ann. 2011-19.

A. General TEB Reissuance Rule Under Notices 2008-41, 2008-88 and 2010-7 and Ann. 2011-19.

In light of recent rating agency downgrades of major municipal bond insurers and failed auctions for auction rate bonds, on March 25, 2008, the Internal Revenue Service issued Notice 2008-41 to modify and clarify the determination of when tax exempt bonds are treated as reissued (treated as a current refunding) or retired (treated as extinguished), solely for tax exempt bond purposes under Code Sections 103 and 141 through 150. Notice 2008-41, effective as of March 25, 2008, is intended to clarify, amend, supplement, and supersede Notice 2008-27, which had provided slightly different reissuance standards for "qualified tender bonds" from those in Notice 88-130. Notice 2008-41 was amended and supplemented by Notice 2008-88 and was modified by Notice 2010-7.

Notices 2008-41, 2008-88 and 2010-7 contain many special rules designed to provide greater flexibility with respect to post-issuance alterations to tax exempt bonds without creating a TEB Reissuance. Some of those specific rules are designed to deal with current liquidity concerns caused by bond insurers' ratings downgrades and have expiration dates or otherwise provide only temporary relief. Notice 88-130 remains in effect.

Notice 2008-41 provides a general rule that a tax-exempt bond is treated as reissued or retired, for TEB purposes, on the first date on which: (i) a significant modification of the bond terms occurs under the Reissuance Regulations or a disposition of the bond occurs under Code Section 1001; (ii) the bond is purchased or otherwise acquired by or on behalf of the issuer, which is a governmental unit or an agency or instrumentality of the governmental unit; or (iii) the bond is otherwise retired or redeemed. As described below, Notices 2008-41, 2008-88 and 2010-7 provide specific exceptions from, and modifications to, the application of the Reissuance Regulations to determine whether a modification of a tax-exempt bond causes a reissuance or retirement to occur for TEB purposes. See Section III for a discussion of the Reissuance Regulations.

B. General Reissuance Rules Under Notice 2008-41.

1. The Qualified Tender Bond Rule. First and most important is the "Qualified Tender Bond Rule" described in Notice 2008-41, which provides that a "qualified tender bond" will not be treated as reissued solely as a result of (a) a change in the interest rate mode that was authorized under the original terms of the bond, or (b) the existence or exercise of a qualified tender right that was authorized under the original terms of the bond and that provides an optional tender right or a mandatory tender requirement that allows or requires the bondholder to tender the bond for purchase at par in one or more prescribed circumstances (such as in connection with a mode change). For purposes of Notice 2008-41, the term "qualified tender bond" generally includes most variable rate demand bonds (often called "tender option bonds" or "put bonds"), auction rate bonds and multimodal bonds. Note this definition is different than the definition under Notice 88-130.

2. General Rule: Notice 2008-41 Tests for Reissuance by Applying the Reissuance Regulations. Notice 2008-41 provides that, aside from specified exceptions to reissuance, including the Qualified Tender Bond Rule and other special rules described below in Section II.D, a tax-exempt bond is treated as reissued or retired on the first date on which: (a) a significant modification to the terms of the bond occurs under the Reissuance Regulations or a disposition of the bond otherwise occurs under Code Section 1001; (b) the bond is purchased or otherwise acquired by or on behalf of the issuer; or (c) the bond is otherwise retired or redeemed. For tax-exempt bond reissuance purposes, the Reissuance Regulations are applied as modified by Notices 88-130, 2008-41 and 2008-88. See Section II.D.8 for special rules of application to use when applying the Reissuance Regulations to Notice 2008-41.

C. "Qualified Tender Bond" Under Notice 2008-41.

1. Bond-by-Bond Determination. Whether a bond constitutes a qualified tender bond is generally determined on a bond-by-bond basis, unless the context requires a determination of the weighted average maturity of the entire bond issue.

2. Interest Rate. For each pre-authorized interest rate mode considered separately, the bond can bear interest at either a fixed interest rate or a variable interest rate that can reasonably be expected to measure contemporaneous variations in the cost of newly-borrowed funds, including interest rates determined by reference to eligible interest rate indexes (*e.g.*, the SIFMA index), tender option-based interest rate measures, a Dutch auction process, or certain variable rates not previously included in the permitted category, *e.g.*, an eligible objective rate, a qualified inflation rate or a qualified inverse floating rate.

3. Final Maturity. The final maturity date of the bond can be no longer than 40 years (an increase from 35 years permitted in Notice 88-130) after the issue date (or, if less, the latest date that is reasonably expected as of the issue date to be necessary to carry out the governmental purpose of the issue of which the bond is a part, with 120 percent of the weighted average economic life of the financed facilities being a safe harbor for this purpose).

4. Interest Payment Frequency. Interest on the bond must be unconditionally payable at periodic intervals at least annually.

5. Tender Right. The bond must be subject to an optional tender right or a mandatory tender requirement that allows or requires a bondholder to tender the bond for purchase (to the issuer or otherwise) in one or more prescribed circumstances under the terms of the bond.

6. Remarketing Requirement. The terms of the tender right must require the issuer or its remarketing agent to use at least best efforts to remarket the bond upon a purchase pursuant to the tender right.

D. Special Rules Under Notices 2008-41 and 2010-7 and Ann. 2011-19.

1. Holding Period for Tendered Bond. A tendered bond purchased by the issuer may be held by the issuer without being treated as retired provided it is not held by the issuer later than the later of (i) December 31, 2010, or (ii)(a) 180 days after the purchase in the case of purchases before December 31, 2010, or (b) 90 days after the purchase in the case of purchases after December 31, 2010. See Notice 2010-7, 2010-3 I.R.B. 296 modifying Notice 2008-41 and 2008-88. There is no limit on the period that a conduit borrower, such as a hospital or exempt facility owner, or a third-party liquidity provider or third-party guarantor, may own a tendered bond. Under Ann. 2011-19, 2011-11 I.R.B. 553, an issuer may make a payment under VCAP to preserve the refundability of a bond purchased and held beyond December 31, 2010.

2. Holding Period for Bond Purchased in Auction. In the case of issuers of auction rate securities that purchase their bonds by bidding in the auction, the permitted holding period during which there will be no deemed retirement is through December 31, 2010. See Notice 2010-7. No limit is imposed on conduit borrowers.

3. Program Obligation Rule. A special rule effectively exempts conduit borrowers who purchase their own auction rate bonds from the "program investment" prohibition (see Treas. Reg. § 1.148-1(b)) that generally restricts such acquisitions, so long as the purchase was made in order to "facilitate liquidity under adverse market conditions." This special rule may keep conduit borrowers from breaching "program" covenants in their bond documents and from violating certain arbitrage restrictions. See Notice 2008-41.

4. Directly Resulting Interest Rate Variance. In testing modifications of tax-exempt bonds for reissuance, any interest rate variance directly resulting from a qualified interest rate mode change will not be treated as a modification under the Reissuance Regulations, so that interest rate variance need not be tested under the "change in yield" rule for determining a "significant modification." As a result, if a bond insured by a downgraded insurer bore interest at 10% in auction mode, and after conversion to another mode pursuant to the terms of the original bond documents (which did not result in a reissuance of the bonds) bears interest at 3%, that interest rate decrease will not cause a reissuance so long as the decrease is the direct result of a qualified interest rate mode change. Similarly, if the addition or substitution of credit enhancement does not constitute a "significant modification," any

directly resulting interest rate variance need not be tested under the Reissuance Regulations' "change in yield" rule. See Notice 2008-41.

5. Hedge Modification. Solely for arbitrage investment restrictions, modification of an integrated (qualified) hedge is not treated as a termination of the hedge if both: (a) the modification is not reasonably expected as of the date of the modification to change the yield on the affected hedged bonds over the remaining term of the hedged bonds by more than one quarter of one percent (0.25 percent or twenty-five basis points) per annum, and (b) the payments and receipts on the qualified hedge, as modified, are fully taken into account as adjustments to the yield on those hedged bonds for arbitrage purposes. See Notice 2008-41.

6. Hedge Not Deemed Terminated Due to Issuer Holding Bonds During Permitted Period. For arbitrage purposes, an integrated (qualified) hedge is not deemed terminated as a result of the Issuer holding the hedged bonds during any holding period during which the Issuer is permitted to hold such bonds without resulting in a reissuance or retirement of such bonds (*e.g.*, through December 31, 2010, described in Section II D.1 and 2, above). See Notice 2008-41.

7. Premium Bonds. Upon a conversion of a qualified tender bond to an interest rate mode that is a fixed interest rate for the remaining term of the bond to maturity, the bond may be sold at a market premium or a market discount and the conversion can still qualify as a qualified interest rate mode change. Solely for arbitrage purposes, any premium received by an issuer pursuant to a conversion of a qualified tender bond to a fixed interest rate to maturity in a qualified interest rate mode change is treated as additional sale proceeds of such bond. This rule does not address whether a reissuance occurs due to an amendment permitting bonds to be converted to fixed rate bonds sold at a premium. Such amendment would be a modification that must be analyzed for significance under the Reissuance Regulations.

8. Special Rules of Application to be Used When Applying the Reissuance Regulations to Notice 2008-41.

a. General Rule of Application. Except as otherwise specifically provided in Notice 2008-41, the determination of whether any modification to an issue of tax-exempt bonds causes a reissuance or retirement of the tax-exempt bonds for purposes of Code Sections 103 and 141 through 150 is based on whether the modifications are significant modifications under Treas. Reg. § 1.1001-3. See Notice 2008-41, Section 3.1.

b. Interest Rate Variance Resulting from Qualified Interest Rate Mode Change. In applying Treas. Reg. § 1.1001-3 to modifications of tax-exempt bonds, any interest rate variance directly resulting from a qualified interest rate mode change is not treated as a modification under Treas. Reg. § 1.1001-3, and thus such interest rate variances need not be tested under the change in yield rule for determining significant modifications under Treas. Reg. §1.1001-3(e)(2). See Notice 2008-41, Section 3.1.

c. Special Rule for Nonrecourse Debt. Solely for purposes of Code Sections 103 and 141 through 150, in applying Treas. Reg. § 1.1001-3(e)(4)(iv)(B) to determine whether a modification of the security or credit enhancement on a tax-exempt bond that is a nonrecourse debt instrument is a significant modification, such a modification is treated as a significant modification only if the modification results in a change in payment expectations under Regulation §1.1001-3(e)(4)(vi). See Notice 2008-41, Section 6.1.

d. Special Temporary Relief for Certain Waivers of Interest Rate Caps on Auction Rate Bonds. Solely for purposes of Code Sections 103 and 141 through 150, in applying Treas. Reg. § 1.1001-3(e)(2) to determine whether a modification to the yield on tax-exempt bonds that bear interest based on an auction rate constitutes a significant modification, a temporary waiver, in whole or in part, of the terms of a cap on the maximum interest rate on such auction rate bonds is disregarded to the extent that any agreement to waive such a cap and the period during which such a waiver is in effect both are within the period between November 1, 2007 and December 31, 2010. See Notice 2010-7. Except for the special relief provided in this section, a waiver of a cap on an interest rate on a tax-exempt bond generally is required to be tested for whether it causes a significant modification under Treas. Reg. §1.1001-3. See Notice 2008-41, Section 6.2.

E. Reissuance of Build America Bonds, Chief Counsel Advice Memorandum 2014-009.

On December 19, 2014, the IRS released a Chief Counsel Advice Memorandum 2014-009 concluding that the legal defeasance of a direct pay Build America Bond was a reissuance of the Build America Bond, and therefore, the reissued bonds would not qualify as Build America Bonds because the authority to issue Build America Bonds expired on December 31, 2010. As a result, upon reissuance of the Build America Bond, the issuer would no longer be eligible to collect the direct subsidy payments authorized under Section 6413 of the Code. The issuer argued that the definition of a tax-exempt bond under Treas. Reg. 1.1001-3(f)(5)(iii) applied to Build America Bonds as well because Build America Bonds are state or local bonds that must meet the requirements of Section 103 of the Coe to qualify as Build America Bonds. The IRS did not agree. The IRS concluded that the special exception for tax-exempt bonds with respect to legal defeasance should not apply to Build America Bonds because the IRS did not change the definition of tax-exempt bonds in the Treas. Reg. 1.1001 following authorization of Build America Bonds. Further, the IRS rationalized that the reissuance would not harm bondholders who were already receiving taxable interest.

III. Reissuance Under the Reissuance Regulations (Treas. Reg. § 1.1001-3).

A. Focus on Issuer-Holder Transactions.

In general, the Reissuance Regulations apply broadly to debt modifications, regardless of form. The Reissuance Regulations focus mainly on so-called "issuer-holder" transactions involving negotiations between issuers and holders to modify the terms of a debt. Treas. Reg. § 1.1001-3(a)(1) provides that the Reissuance Regulations also apply to a debt modification that

an issuer and holder accomplish indirectly through one or more transactions with third parties. However, the Reissuance Regulations are inapplicable to exchanges of debt instruments between holders, or so-called "holder-holder" transactions.

B. Special Definitions for Tax-Exempt Bonds.

Treas. Reg. § 1.1001-3(f)(6) includes special rules for purposes of applying the Reissuance Regulations to tax-exempt bonds.

1. Obligor Is Actual Issuer. Although the Reissuance Regulations generally use the terms "issuer" and "obligor" interchangeably, they generally treat the actual issuer of a tax-exempt bond as the issuer and obligor, and not a conduit borrower of the bond proceeds. This special rule generally is helpful because it narrows the circumstances in which an action involving conduit borrowers or conduit loans may cause a reissuance of tax-exempt bonds.

2. Side Agreements Between Conduit Borrower and Bondholder. An accompanying anti-abuse rule provides that transactions between a bondholder and a conduit borrower may result in indirect modifications and must also be considered in analyzing whether there has been a significant modification. For example, if a bondholder pays a conduit borrower to waive a call right, that may cause an indirect modification of the tax-exempt bond as a result of a change in yield.

3. Participation by Conduit Issuer. In addition, an agreement between the conduit borrower and the bondholder that does not include the participation of the governmental issuer of the bond may affect whether the modified obligation will be considered an obligation of the governmental conduit issuer. If the modified obligation is deemed not to be the obligation of a state or local governmental issuer, the interest on the modified obligation will no longer be tax-exempt. Care should be taken, particularly in workout situations in which the obligations of the conduit borrower are being renegotiated with the bondholders, to involve the governmental issuer. Otherwise, the IRS could deem the obligation not to be an obligation of the governmental issuer, causing the bonds to lose their tax-exempt status, as in Rev. Rul. 81-281.

4. Special Definition of Recourse Debt. Generally, the Reissuance Regulations treat a tax-exempt bond that does not finance a conduit loan as a recourse debt. Also, a tax-exempt bond that does finance a conduit loan is a recourse debt unless both the bond and the conduit loan are nonrecourse instruments. For this purpose, under Code Section 150, a conduit loan includes a purpose investment loan, such as a qualified mortgage loan, a loan to a 501(c)(3) organization, or a loan to a private borrower in a qualified private activity bond transaction. These rules generally are helpful, since the threshold for reissuance of a recourse debt generally is higher than that for a nonrecourse debt. One notable exception provides that certain tax-exempt bonds defeased with certain taxable or tax-exempt government securities are nonrecourse debt.

C. General Two-Part Reissuance Test: Modification and Significance.

In general, the Reissuance Regulations establish a two-part reissuance test. A reissuance occurs only if both (a) a modification of a debt occurs, *and* (b) the modification is significant.

1. Definition of Modification.

a. Modification in General Timing. Subject to an exception for certain alterations (or "changes") that occur by operation of the terms of a debt, Treas. Reg. § 1.1001-3(c)(1)(i) generally defines modification broadly to include any change, including any addition or deletion, in a legal right or obligation of the issuer or holder of a debt, whether evidenced by writing, conduct, or otherwise. In general, a modification occurs at the time the parties agree upon the modification, not when it goes into effect. Treas. Reg. § 1.1001-3(c)(6).

b. Exception: Certain Changes by Operation of the Terms of a Debt Are Not Modifications.

(i) General Exception - Changes by Operation of Terms of Debt Instrument Are Not Modifications. Treas. Reg. § 1.1001-3(c)(1)(ii) provides that most (but not all) changes in a debt that occur by operation of the terms of the debt are not modifications. For example, a change may occur by operation of the terms if it occurs automatically (*e.g.,* changes in variable interest rates based on values of interest indexes) or upon exercise of certain unilateral options. This exception underscores the importance of pre-issuance planning.

(ii) Certain Unilateral Options Are Not Modifications. Treas. Reg. § 1.1001-3(c)(2)(iii) provides that changes to a debt that result from the exercise of an option provided to the issuer or the holder in the debt instrument is a modification unless the option is unilateral. For a unilateral option exercisable by a bondholder, however, an additional condition provides that it qualifies for an exception to modification treatment only if it does not result in any deferral of or reduction in any scheduled payment of debt service. PLR 201149017 indicated that bonds subject to mandatory tender could be eligible for unilateral option treatment. This PLR related to Build America Bonds and held that a modification made by an issuer that gave rise to a mandatory tender was a unilateral modification because the bondholder did not have any options as a result of the issuer change. An argument had been made that the bonds should have been analyzed under the tax-exempt bond reissuance notices because the Build America Bonds had a similar tax-favored status. The Service gave the favorable result based upon its interpretation of "unilateral option," but declined to treat the Build America Bonds as subject to the tax-exempt bond reissuance notices.

An option is a unilateral option if: (A) it provides no counter-rights to the other party to terminate, alter, or put the debt to a person related to the issuer, (B) it requires no consents, and (C) it requires no consideration except for incidental costs and expenses of exercise and other consideration that, as of the original issue date of the debt, was *de minimis*, specified, or based on an objective financial formula.

Practitioners should consider this important unilateral option exception because, with careful tax planning, this exception may have practical application to various transactions to reduce the incidence of reissuances. For example, a conversion from a floating interest rate to a fixed interest rate could be structured to satisfy the unilateral option definition if the fixed rate were set pursuant to an objective financial formula specified on the issue date. Similarly, this exception could apply to detachable call options.

2. Certain Changes Are Always Modifications. Treas. Reg. § 1.1001-3(c)(2) provides that certain changes are always modifications, even if they occur by operation of the terms of a debt instrument. These include (i) changes in obligor, (ii) changes in the recourse or nonrecourse nature of a debt, (iii) changes that create non-debt (other than certain stock conversion options), (iv) non-unilateral options, and (v) holder options, even unilateral options, that defer or reduce scheduled debt service payments. Thus, these changes always need to be tested for significance.

3. Failure to Perform and Temporary Forbearance Is Not a Modification. Treas. Reg. § 1.1001-3(c)(4)(i) generally does not treat an issuer's failure to perform its obligations under a debt instrument as a modification. In addition, Treas. Reg. § l.1001-3(c)(4)(ii) provides that a holder's temporary forbearance to stay collection or waive default rights for a period of up to two years, plus any additional period during which the parties conduct good faith workout negotiations or a bankruptcy case is pending, is not a modification. These provisions should accommodate many workouts.

D. Significance of a Modification.

1. Introduction to Bright-Line and Catch-All Significance Tests. Once a "modification" of a debt within the meaning of Treas. Reg. § 1.1001-3(c) of the Reissuance Regulations has occurred, that modification gives rise to a reissuance only if that modification is "significant" under Treas. Reg. § 1.1001-3(e). The Reissuance Regulations employ a tricky combination of bright-line tests and a catch-all "general economic significance" test to determine whether a modification is significant. And, for TEB Reissuance purposes, some of those tests are modified by Notice 2008-41. See Section II.D.8 above for rules of application to TEB Reissuance.

For modifications involving certain specific types of changes, including changes in yield, changes in timing of payments, changes in obligor or security, changes in the debt character or recourse nature, and changes in financial covenants, Treas. Reg. § 1.1001-3(e)(2)

through (6) provide specific bright-line rules to determine whether those changes are significant.

For modifications involving changes of a type other than those to which the bright-line rules apply, a catch-all "general economic significance" rule applies, taking into account all the facts and circumstances.

2. Catch-All General Economic Significance Test. Treas. Reg. § 1.1001-3(e)(1) provides that any modification, other than one to which any of the bright-line rules applies, is significant if the legal rights or obligations changed and the degree thereof are "economically significant," based on all the facts and circumstances. This catch-all economic significance rule considers all covered modifications in the aggregate, and most closely reflects prior law. The Reissuance Regulations unfortunately provide no guidance on what is economically significant and thus perpetuate some of the uncertainty. Still, this general rule provides some flexibility and may be needed for circumstances not otherwise addressed. In PLR 200652043 (September 21, 2006), the IRS determined that the partition of a life insurance contract between two banks under a common parent entity, prior to liquidation of the parent entity, which owned the original insurance contracts, did not constitute a sale or other disposition exchange under Code Section 1001 where each bank's share of the partitioned contract was based on its respective ownership of the original contract. The ruling cites Treas. Reg. § 1.1001-1(a) rather than Treas. Reg. § 1.1001-3. PLR 200742016 (October 19, 2007) found a significant modification where recourse debt of one subsidiary (which was guaranteed by the common parent) was exchanged for similar debt of another subsidiary (also guaranteed by the common parent) because of the change in the primary obligor of a recourse debt instrument.

E. The Bright Line Tests for "Significance" of a Modification.

1. Changes in Yield.

a. In General. Treas. Reg. § 1.1001-3(e)(2) provides that a change in the yield of a debt is significant if the annual yield of the modified debt varies from that of the original debt by more than the greater of: (i) one-fourth of one percent (*i.e.*, 25 basis points), or (ii) five percent (5%) of the yield on the original debt (*i.e.*, 0.05 multiplied by the annual yield).

b. Mechanics of Yield Calculation. The Reissuance Regulations also provide technical guidance on how to measure yield for purposes of this rule. Treas. Reg. § 1.1001-3(e)(2)(iii). For this purpose, yield means the annual yield. Annual yield is based on the adjusted issue price on the unmodified debt as of the date of the modification, adjusted upward for accrued unpaid interest and amounts received by the issuer as consideration for the modification, and adjusted downward for accrued unamortized bond insurance premium and amounts paid by the issuer as consideration for the modification. Annual yield takes into account payments on the modified debt going forward. Note that yield, for purposes of the Reissuance Regulations, does not take into account the special amounts, including qualified guarantee fees and qualified hedge fees, that yield for arbitrage purposes takes into account under Code Section 148. For variable

rate debt, a rule of convenience uses the hypothetical yield on an equivalent fixed rate debt as of the date of the modification to test yield changes. In contrast to Code Section 148, under the Reissuance Regulations yield is not computed in separate 5-year segments.

c. Relevance to General Economic Significance. Many debt modifications affect yield and will need to be tested under this yield change rule. One issue raised is whether the yield change benchmark has any relevance by analogy in determining whether other kinds of changes are significant under the general economic significance rule. It would seem reasonable in appropriate circumstances to look at the effect on yield as a proxy for general economic significance.

2. Changes in Timing of Payments.

a. Material Deferral is Significant. Treas. Reg. § 1.1001-3(e)(3)(i) provides that a modification that involves a "material deferral" of scheduled debt service payments, including either principal or interest, is significant. The deferral may result from an extension of the final maturity date or the deferral of payments due before maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the debt, and the amounts deferred.

b. Safe Harbor Deferral Period. A bright-line safe harbor exception under Treas. Reg. § 1.1001-3(e)(3)(ii) largely consumes the general rule for planning purposes. The safe harbor treats a deferral of one or more scheduled payments as insignificant if it does not exceed the lesser of (i) five years from the original due date of the first scheduled payment that is deferred, or (ii) 50 percent of the original term of the debt, and the deferred payments are unconditionally payable no later than at the end of the safe harbor period. This safe harbor is more restrictive than the IRS's position in Rev. Rul. 73-160, which held that any mere extension of maturity was not a reissuance. The continuing reliability of that ruling, however, already was the subject of considerable debate. This safe harbor permits reasonable extensions of maturity that should accommodate many workouts.

3. Changes in Obligor and Security.

a. Introduction. Treas. Reg. § 1.1001-3(e)(4) provides a number of complex rules to determine when modifications that involve changes in obligor or security for a debt are significant. The Reissuance Regulations make various distinctions based on factors such as whether a debt is recourse or nonrecourse, whether the change affects payment expectations, or whether the debt is tax-exempt. As previously indicated, special rules apply to tax-exempt bonds to test changes in obligor and security. The obligor on a tax-exempt bond generally is the actual issuer and any third-party conduit borrower is disregarded. Treas. Reg. § 1.1001-3(f)(6)(i). In addition, a tax-exempt bond that finances no conduit loans is treated as a recourse debt and a tax-exempt bond that finances conduit loans also is treated as a recourse debt unless both the tax-exempt bond and the conduit loan are nonrecourse, in which case the bond is treated as nonrecourse. Treas. Reg. § 1.1001-3(f)(6)(ii).

b. Change in Obligor Significant For Recourse Debt. Treas. Reg. § 1.1001-3(e)(4)(i)(A) provides that the substitution of a new obligor on a recourse debt generally is significant. A special rule for tax-exempt recourse debt provides that the substitution of a new obligor, *i.e.*, the actual issuer, is insignificant if the new obligor is related to the issuer and the collateral security continues to include the original collateral. Treas. Reg. § 1.1001-3(e)(4)(i)(D).

Under other recourse debt exceptions, the substitution of a new obligor is not significant in certain nonrecognition corporate transactions under Code Section 381 in which payment expectations (as discussed below) remain unchanged, certain bankruptcy transactions, and certain acquisitions of substantially all the assets of an original obligor in which payment expectations remain unchanged.

c. Change in Obligor Generally Insignificant for Nonrecourse Debt. For nonrecourse debt, the substitution of a new obligor is insignificant. The significance of changes in nonrecourse debt focuses on changes in security. Treas. Reg. § 1.1001-3(e)(4)(ii). Treas. Reg. § 1.1001-3(e)(4)(iii) further provides, however, that the addition or deletion of a co-obligor on any debt, recourse or nonrecourse, is significant if it changes the "payment expectations."

d. Change in Payment Expectations Standard. Treas. Reg. § 1.1001-3(e)(4)(vi) provides that a change in payment expectations occurs if the obligor's capacity to meet debt payment obligations is "primarily speculative" before the modification and the modification substantially enhances that capacity so as to make it "adequate" afterwards, or vice-versa. Payment capacity takes into account security, guarantees, and credit enhancement. Notably, the preamble to the Reissuance Regulations indicates that if the obligor has at least an "adequate capacity" to meet its debt payment expectations both before and after a modification, then no change in payment expectations occurs.

e. Changes in Security on Recourse Debt. Treas. Reg. § 1.1001-3(e)(4)(iv)(A) provides that, for recourse debt, any modification that changes the security, including any modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for, a recourse debt is significant if it changes payment expectations. This requirement that a change in security on recourse debt must also result in a change in payment expectations is important and narrows considerably the circumstances in which this rule will trigger any reissuances of recourse debt. Since most tax-exempt recourse debt has at least adequate capacity to pay debt service, changes in security for such debt should result in a reissuance only in limited circumstances.

f. Changes in Security on Nonrecourse Debt. For changes in security on nonrecourse debt, Treas. Reg. § 1.1001-3(e)(4)(iv)(B) provides broadly that a modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other credit enhancement on a nonrecourse debt generally is significant. In one potentially helpful but unclear exception, the substitution of similar commercially available credit enhancement is insignificant. It is unclear what

constitutes "similar" credit enhancement. Substitutions of fungible collateral (*e.g.*, government securities) and improvements to property securing a nonrecourse debt also are insignificant. For purposes of Notice 2008-41, Treas. Reg. § l.1001-3(e)(4)(iv)(B) is modified so that a change in security on a non-recourse tax-exempt bond is treated as a significant modification only if it results in a change in payment expectations under Treas. Reg. § 1.1001-3(e)(4)(vi).

g. Changes in Priority of Debt. Treas. Reg. § 1.1001-3(e)(4)(v) provides that a modification that results in a change in the priority of a debt is significant if it results in a change in payment expectations.

4. Changes in the Nature of Debt.

a. Changes Into Non-Debt. Treas. Reg. § 1.1001-3(e)(5)(i) provides that a modification that changes a debt into equity or other non-debt property is significant. In a useful limitation, that section further provides that, for this purpose, a deterioration in an obligor's financial condition may be generally disregarded.

b. Changes in Recourse Nature. Treas. Reg. § 1.1001-3(e)(5)(ii) provides that a modification that changes the nature of debt from recourse to nonrecourse, or vice-versa, generally is significant. For example, a legal defeasance of a debt in which the issuer is released from all liability to make payments on the debt is a significant modification. Although there is a special rule that provides the defeasance of a tax-exempt bond with certain taxable or tax-exempt government securities is not a significant modification, it should be noted that a legal defeasance of taxable debt of a governmental issuer does not qualify for this exception and will be treated as a significant modification. Another special rule treats a change from a recourse debt to a nonrecourse debt as insignificant if the debt continues to be secured by the original collateral and no change in payment expectations occurs.

5. Accounting or Financial Covenants. Treas. Reg. § 1.1001-3(e)(6) provides that a modification that changes customary accounting or financial covenants is insignificant.

6. Certain Rules of Application.

a. In General. Treas. Reg. § 1.1001-3(f) provides rules of application for testing the significance of modifications. Any modification must be tested under *each* bright-line rule under Treas. Reg. § 1.1001-3(e)(2) through (6) that applies to the type of modification, and, if the modification is of a type not specifically addressed by those bright-line rules, it must be tested under the catch-all general economic significance rule. Thus, for example, a deferral of payments that changes the yield must be tested under both the yield change rule and the payment deferral rule.

b. Contingent or Deferred Modifications Under General Economic Significance Rule. If a modification is contingent or deferred, it must be tested under the general economic significance rule in lieu of the bright-line rules. Treas. Reg. § 1.1001-3(f)(1).

c. Cumulative Effect of Modifications Over Time. Two or more modifications of the same kind over time generally must be aggregated to test their significance. Thus, for example, if a series of extensions of maturity would be significant if counted together as a single aggregate extension of maturity, then those extensions are treated as significant. For purposes of testing whether a particular modification causes a significant change in yield, however, an issuer may disregard any prior yield change that occurred more than five years before the modification then being tested. Treas. Reg. § 1.1001-3(f)(3).

d. Separate Effect of Different Kinds of Qualifying Modifications at the Same Time. Two or more modifications of different terms of a debt (as contrasted with a series of modifications of the same term of a debt over time) that are individually insignificant under applicable bright-line tests for significance do not collectively constitute a significant modification. Treas. Reg. § 1.1001-3(f)(2).

Thus, for example, an issuer could change the yield on a debt by less than 25 basis points without giving rise to a significant change in yield and could also temporarily defer payments for the lesser of five years or 50% of the remaining maturity without giving rise to a significant change in timing of payments. Since each of these changes individually is insignificant, they do not become collectively significant.

F. Impact of Reissuance.

If there is a significant modification of the bond terms, the modified bond (and not the whole bond issue of which that bond is a part) is treated as reissued and generally constitutes a current refunding of the unmodified bond for federal income tax purposes. Such a deemed reissuance does not in and of itself cause the modified bond to be taxable. Rather, the modified bond must be analyzed as a newly issued bond for federal income tax purposes and its qualification for tax-exemption with respect to how the bond proceeds (or the property financed by such bond proceeds) were used and whether such bonds violate any arbitrage restrictions must be determined as of the date of the reissuance. Since a reissuance is treated as a "current refunding," exceptions from certain requirements applicable to tax-exempt refunding bonds may apply.

1. Changes in Law. Perhaps one of the most significant impediments to requalification for tax-exemption in the case of a reissued bond is a change in law. If there has been a change in law, such as the imposition of new statutory requirements or new regulatory requirements, since the date the unmodified bonds were issued, the modified bond will be subject to the new requirements unless the modified bonds qualify for a transition rule, if any, that would exempt it from the application of the new requirements.

2. Use of Proceeds Requirements. Another important consequence is the reapplication of the use of proceeds requirements. Under the private activity bond regulations, the bonds and the bond-financed property must reasonably be expected not to meet the private activity bond tests for the term of the bonds. Thus, if the modified bonds are treated as reissued on the modification date, these expectations must be retested on such date.

3. Other Requirements. Other requirements to keep in mind with respect to the modified bonds, particularly if the maturity of the bonds is extended or if the principal amount of the bonds is deferred, are (a) volume cap; (b) limitation of the weighted average maturity to 120% of the reasonably expected useful life of the bond financed property; (c) public approval (TEFRA); (d) rebate; (e) information reporting (Forms 8038 or 8038-G); and (f) specific limitations such as limits on small issue bonds and non-hospital bonds.

G. Impact of Reissuance or Certain Other Modifications on Rebate Liability.

Even if a modification of the terms of the bonds is not treated as a reissuance of the bonds under the Reissuance Regulations, Treas. Reg. § 1.148-4(b)(4) provides that any transfer, waiver, modification or similar transaction of any right that is part of the terms of a bond or associated with a bond (*e.g.,* a redemption right) in a transaction that is separate from the original issuance of the bond will cause the issue (not just the bond affected by the modification) to be treated as retired and a new issue issued on the date of the transfer. This is solely for purposes of computing rebate. Thus, the yield on the original bond issue must be recomputed assuming the bonds are retired on the date of the transfer at a price equal to the aggregate value of all of the bonds of the issue on such date and any rebate liability with respect to such retired bonds must be computed based on such recomputed bond yield and paid to the IRS. The bonds will be treated as reissued on the transfer date with an issue price equal to the aggregate value of such bonds together with any amounts received as consideration for the transfer and the yield on such reissued bonds will be used to determine the rebate liability of such reissued bonds.

Similarly, if a bond is hedged with a superintegrated swap described in Treas. Reg. § 1.148-4(h)(4), a modification of the bond may trigger a deemed termination of the swap or loss of "superintegration," which is treated as a reissuance solely for rebate purposes under Treas. Reg. § 1.148-4(h)(4)(iii)(B) and (C).

IV. Consequences of Reissuance.

The table below lists issues that a practitioner must consider when a reissuance occurs. See also Part A.III.F. Certain Consequences of Refundings under ARRA.

TOPIC	QUERY / IMPORTANCE / NOTES
Change of law	*Query*: Has there been a change of law since issue date of "prior bonds"? *Importance*: A change of law may result in a significant adverse tax consequence unless the bonds qualify for a transition rule that would exempt them from the application of the new requirements.
Forms 8038 or 8038-G	A new Form 8038 or 8038-G must be filed and the issuer's signature is required.
Action by issuer	*Query*: Is it necessary, required or desirable for the issuer to act?
Public approval	*Query*: Is there any need to meet the requirements of public approval for reissued bonds? *Note*: No public approval is required for obligations that currently refund an issue that has been publicly approved, so long as the average maturity of the refunding obligation does not exceed that of the refunded obligation.
Gain/loss to bondholder	*Query*: Does the bondholder have to recognize taxable gain or loss as a result of the reissuance, including recognition of market discount?
Rebate triggered	*Query*: Determine whether the reissuance triggers rebate. If the entire prior issue is reissued, generally this triggers a final rebate computation within 60 days unless an exception applies. But, if only a portion of the outstanding prior bonds are reissued, the reissuance generally does not trigger a final rebate computation and payment.
New yield calculation: new fair market value ("FMV") of bonds	*Query*: What is the new fair market value of the reissued bonds? Do the reissued bonds and investments allocable to the reissued bonds require new yield calculations? Are either the bonds or the investments (or both) required to be marked to market?
Integrated swap/swap termination payments	Reissuance may terminate an existing integrated swap, which can result in bond yield adjustments. *Note*: Swap termination payments, whether they are actual or deemed payments, affect prior bonds and may affect yield on reissued or prior bonds. Formerly integrated swaps that are marked-to-market might qualify for integration with the reissued bonds.
95% expenditure requirement	*Note*: Consider whether prior bonds satisfy the 95% capital cost requirement or the 95% hospital expenditures requirement.

TOPIC	QUERY / IMPORTANCE / NOTES
Non-hospital bonds	*Query*: Are the reissued bonds hospital bonds, non-hospital bonds, capital expenditure bonds, or private activity bonds? (See Code Section 145). *Query*: If the bond is a non-hospital bond, consider whether there are new users or related parties that are treated as "Test Period Beneficiaries" of the reissued bonds. (See Code Section 144(a)(10)(D)). *Query*: Do the new Test Period Beneficiaries have any effect on the $150 million cap? *Query*: If the issue includes non-hospital bonds, determine if the $150 million cap has been exceeded.
Retest all limitations ($40 million and $150 million)	Retest the $40 million limitation under Code Section 144(a)(10) or the $150 million limitation on non-hospital bonds applicable to qualified 501(c)(3) bonds under Code Section 145(b). *Importance*: If the bonds are subject to either the $40 million limit or the $150 million limit, the "Test Period Beneficiary" rules of Code Section 144(a)(10) are applicable to the reissued bonds, since a new test period is triggered by the reissuance. See Code Section §144(a)(10)(D). *Importance*: If the $150 million limitation is violated with respect to an issue by a change of owners or principal users of bond-financed facilities at any time during the three-year test period, the interest on that issue is taxable from the date the bonds were issued. (See HR Rep. No. 426, 99th Cong., 1st Session, December 7, 1985, page 540.)
Private use recalculation	*Importance*: Are there any new non-qualifying uses? For governmental bonds and qualified 501(c)(3) bonds, the new private activity refunding regulations will apply. See Treas. Reg. § 1.141-13. Since the reissued bonds are a new "issue," a "bring-down" due diligence certificate may be required.
Allocation of reissued bonds	The allocation of reissued bonds to uses of proceeds and useful lives should be checked.
120% weighted average maturity ("WAM") limit	*Query*: Determine if the weighted average maturity of the reissued bonds exceeds 120% of the weighted average reasonable expected economic life of the facilities financed with the reissued bonds. Also, check the WAM of any remaining bonds that were not treated as reissued. This is important if the maturity date has been extended.
Volume cap	*Query*: Determine whether private activity bond volume cap is required. (See Code Section 146(a).
Capital expenditures test	*Query*: Determine whether a qualified small issue private activity bond has exceeded the $10 million capital expenditures limitation. Reissuance triggers a new capital expenditure period with a 3-year look-back and 3-year look-forward.
Tax Agreement/Certificate	A new or supplemental tax agreement or certificate is likely needed for the reissued bonds.
Purchase price certification and FMV required	May need certification of purchase price and fair market value.
Opinions	*Query:* Are opinions such as a no adverse effect or a full tax opinion required?

TOPIC	QUERY / IMPORTANCE / NOTES
Temporary period	*Note*: The remainder of the original temporary period for sale and investment proceeds of prior bonds continues after they become transferred proceeds, so those amounts are generally entitled to the remainder of the original temporary period (*e.g.,* 3 years minus the time elapsed from the issue date of the prior bonds).
Transferred proceeds	*Note*: Unspent sale and investment proceeds and transferred proceeds of prior bonds transfer and become proceeds of reissued bonds on date that proceeds of reissued bonds are deemed to pay principal of prior bonds. Note that yield restriction of a reissued advance refunding bond (treated as a current refunding of an advance refunding) may be satisfied by paying yield reduction payments.
Timing	Reissuance generally occurs as of date the modification is agreed to, not date that modification becomes effective. Treas. Reg. § 1.1001-3(c)(6).