Bond Case Briefs

Municipal Finance Law Since 1971

IRS Issues Favorable But Limited Ruling on Total Return Swaps.

WASHINGTON – The Internal Revenue Service has issued a favorable but limited private-letter ruling concluding a total return swap entered into between a borrower and a bank at the same time the underlying tax-exempt bonds were sold is "not an abusive arbitrage device," tax lawyers said.

The IRS always cautions that its PLRs are based on specific transactions or fact patterns and should not be read broadly to cover other deals. But muni market participants typically read them for clues in areas where there is no current tax guidance.

Tax lawyers said the letter-ruling is favorable to primary market total return swaps and the ever growing number of bank loans that are hedged. The PLR answers some tax questions about TRS that had been troubling, they said. However, because of the narrow facts of the case, the ruling is limited, and the IRS gives no rationale for its conclusions, several of them added.

"I think it's a good ruling," said Rich Moore, a partner at Orrick, Herrington & Sutcliffe in San Francisco. "I think it made clear that if there are no bond proceeds subject to rebate, there is nothing inappropriate about a borrower using a total return swap to hedge its interest rate exposure."

IRS agents have taken positions contrary to that in audits in the past, some lawyers said.

"The ruling indicates that there is nothing improper or abusive per se about the use of a total return swap in connection with a tax-exempt bond issue in a primary market transaction," said Hobby Presley, Jr., a partner at Balch & Bingham in Birmingham, Ala. "The ruling also indicates that it's possible for a bondholder who buys a tax-exempt bond in a primary market transaction to provide a hedge agreement with respect to that bond."

The PLR, which did not identify the parties involved, seems to suggest that a borrower can elect not to integrate its bonds and a total return swap to determine the bond yield for rebate purposes and that the IRS will honor that election, some of the lawyers said.

"I think [the PLR] is favorable, but it doesn't answer all the questions that may be relevant for transactions, said David Cholst, a partner with Chapman and Cutler in Chicago. "This was a fact pattern that assumed away some of the concerns that have been raised in some transactions."

TRS', possibly hundreds of which have been done over many years, hedge interest rate risk and lower the cost of borrowing for a conduit borrower, while providing banks with earnings – possibly more than they would receive from letter of credit or direct loan fees. TRS may also provide banks with deductions of their losses from the swap payments, though this is the case with all swaps.

These involve conduit bond deals. The borrowers are almost always nonprofit hospitals, which tend to have a lot of cash reserves on hand for liquidity purposes. Initially, TRS' were secondary market transactions. They were done to allow bonds to retain their insurance. They also are used to allow borrowers to refinance their bonds when the tax law does not permit them to do an advance refunding.

Most TRS are done today in primary market transactions. These transactions involve-long term bonds and a short-term TRS. In such deals, a hospital through an issuer privately places long-term bonds with a bank, which then enters into a much shorter term TRS with the hospital. The bank becomes the holder of the bonds as well as the swap counterparty.

The borrower typically swaps fixed for variable rates to lower its cost of borrowing. It also takes risk and provides price protection for the bank/bondholder/swap counterparty. When the TRS terminates, or is terminated, the bonds are valued. If the bonds' value is below par, the hospital pays the bank. If the value is above par, the bank pays the hospital. But many TRS' are rolled over or replaced and new negotiated terms during the life of the bonds. The hospital could be forced to pay if interest rates rise.

The bank/bondholder/swap counterparty makes money from the higher tax-exempt bond rate and its deduction of its loss from the swap payments.

Example

For example, a hospital will privately place 30-year fixed-rate bonds with a tax-exempt coupon of 5% with a bank. The bank will then enter into a three-year TRS with the hospital. The bank will pay the hospital a variable rate based on the Securities Industry and Financial Markets index plus 100 basis points. If the SIFMA index is 1%, the bank will pay the hospital a total of 2%, taking into account the 100 basis points. The hospital will pay the bank/bondholder the 5% tax-exempt interest on the bonds. That interest rate may be worth more like 7.5% to the bank, when one takes into account its corporate tax rate. The hospital will also make a swap payment to the bank of SIFMA plus 100, or 2%. The bank will make a swap payment to the hospital of 5%.

In this example, the borrower's net cost of borrowing is lowed from 5% to SIFMA plus 100 basis points, or 2%. The bank is getting 5% tax-exempt interest on the bonds, which might be worth more like 7.5% to it, and it can also take a deduction for a 3% loss on the swap (the total of the 5% swap payment it makes to the borrower minus the 2% swap payment it receives from the borrower).

Some sources question whether the bank should be allowed to take the deduction. But the lawyers said banks have many loss carry forwards and that, in any case, this is a question for bank regulators, not the IRS. They also point out that there's always a risk that variable rate bond rates will rise and there will be no deduction.

In the early 2000s, TRS' were done with so-called coerced tenders that were designed to get the bonds in the hands of the bank. The issuer would tell investors they could tender the bonds back to it at a premium, say 101, or wait for the bond call at par. Most investors wanted the premium, but fund managers and analysts were upset that these high-coupon bonds were being taken from them sooner than expected and they began complaining loudly to the press and regulators.

The IRS began auditing these secondary market transactions toward the end of that decade and raised concerns that a TRS either caused the bonds to be reissued and subject to the most recent tax law changes. The Service also said the deal constituted an abusive arbitrage device that could force the integration of the bond and the swap. Integration could lead to a lower bond yield and therefore, a lower investment yield if the hospital wanted to avoid arbitrage earnings that would have to be rebated.

Under the tax law, issuers or borrowers can elect whether or not to integrate the bond and swap. But if the IRS Commissioner finds a transaction is an abusive arbitrage device, he or she and can force the issuer or borrower to integrate the bonds and swap, which might lower the bond yield, and therefore the investment yield.

The PLR

The IRS private-letter ruling was based was a primary market transaction that involved long-term tax-exempt bonds privately placed with a bank and a short-term TRS that was entered into at the same time the bonds were placed. The borrower and bank wanted to extend to the TRS by five years. The pricing of the extended TRS was to be amended so the borrower's net financing would be reduced to the SIFMA index plus 80 basis points.

The bond proceeds had all been used to current refund some previously issued bonds, as well as to pay issuance costs. As a result, there were no proceeds remaining and there was no debt service reserve fund, for which arbitrage might have had to have been rebated. A debt service reserve fund typically holds a year's worth of interest rate payments. If there had been bond proceeds or a reserve fund outstanding, the IRS could have questioned whether rebate calculations should have been based on the bond yield or an integrated bond and swap. But the facts of the case rendered this issue moot.

The IRS said there were no replacement proceeds. Under the tax rules, if a transaction is found to be an abusive arbitrage device, the Commissioner can decide that even though no bond proceeds remained, the hospital's funds could serve as replacement proceeds for the bond proceeds and cause arbitrage problems.

"There are no replacement proceeds otherwise created and no transferred proceeds were received," the IRS said in the PLR. "The proposed extension of the TRS does not affect the gross proceeds of the bonds…."

The IRS declined to take any position whether the TRS extension would cause a reissuance. The issuer and the bank/bondholder/swap counterparty, as a precautionary step, filed another Form 8038 for the bonds in case the IRS decided there was a reissuance. But in that Form 8038, which issuers file for the issuance of 501(c)(3) bonds for nonprofits, they did not include any election to integrate the bonds and swap.

"We specifically express no opinion about whether of the TRS causes a reissuance under Section 1001 [on reissuance] or about issuer's precautionary treatment of such extension as a reissuance," the IRS said in its PLR.

The lawyers said that reissuance wouldn't pose problems for current TRS' because there have been no tax law changes in recent years that could be applied to these transactions.

The IRS found the transaction was not an abusive arbitrage device because it did not exploit the difference between tax-exempt and taxable rates and it did not overburden the tax-exempt bond market.

"We conclude that the original structure of the financing plan, including the TRS, and the extension of the TRS for the bonds, does not enable the borrower to exploit a difference between tax-exempt and table interest rates to obtain a material financial advantage," the IRS said. "The financing structure does not result in any gross proceeds available for non-purpose investment beyond the first 30 days during which initial time period they qualified for an applicable temporary period. The financing structure and the terms of the TRS extension do not reflect an intent to exploit tax-exempt versus taxable interest rate differentials for arbitrage purposes. Since rate exploitation is not present, it is unnecessary to determine if overburdening is present."

Regarding the question of whether the bonds and TRS should be integrated, the IRS said: "We conclude that the structure of the original financing, including the TRS, and the proposed extension of the TRS, does not reflect a principal purpose by the borrower to obtain a material financial advantage by either rate exploitation or by overburdening. Improved market conditions and the improved credit quality of the borrower are the motivating factors for the extension. The modified pricing reflected in the extension was negotiated in an arms' length transaction based on fair market value pricing and not on the amount of arbitrage earned or expected to be earned on the hedged bonds in a manner that is inconsistent with the purposes of Section 148." That section of the Internal Revenue Code contains arbitrage provisions and defines an arbitrage bond, which is taxable.

THE BOND BUYER

BY LYNN HUME

JAN 26, 2015 11:05am ET