Municipal Bond Interest Paid By a Bond Insurer After an Issuer's Bankruptcy Discharge Can Remain Tax-Exempt: Mintz Levin.

In the aftermath of recent municipal bankruptcies in which issuers proposed and/or implemented bankruptcy plans involving partial discharges of the issuer's payment obligation on insured bonds, there has been increased focus on whether municipal bond interest paid by a bond insurer after the bankruptcy plan's effective date continues to be tax-exempt.

Market confusion as to the treatment of bond insurance payments in the discharged issuer context is at least partially attributable to an incomplete understanding of why bond insurer payments of municipal bond interest are deemed tax-exempt in other contexts. Although the IRS has not specifically addressed the tax status of bond insurer payments following the issuer's partial (or full) discharge in bankruptcy, review of IRS rulings on bond insurance suggests that, in ordinary circumstances, interest on the insured bond continues to be tax-exempt notwithstanding that the only source of payment is the bond insurance.

The technical basis for the continued tax-exemption of post-discharge interest is discussed in detail below. The analysis is rooted in one simple concept articulated in an IRS revenue ruling: in ordinary circumstances, a payment by a bond insurer is deemed, for tax purposes, to have been made by the issuer of the bonds. For this reason, although a bankruptcy may, for non-tax purposes, discharge an issuer from further liability on all or a portion of bond payments, for tax purposes the bond payments made by the bond insurer continue to be treated as being made by the issuer. All else is detail, for those with an interest in such detail.

And so, on to the technical discussion.

The tax-exempt treatment of interest paid by a municipal bond insurer is founded on a trio of favorable IRS revenue rulings, which, unlike private letter rulings, are statements of IRS policy on which the market can rely.

The first such ruling, Revenue Ruling 72-134, dealt with the situation where the issuer pays for bond insurance when the bonds are issued, and concluded that "defaulted interest paid by the independent insurance company is excludable from the gross income of the bondholders."

Revenue Ruling 72-575 extended such favorable treatment to a bond insurance policy purchased by the underwriter, and Revenue Ruling 76-78 went a substantial step further, upholding the tax-exemption of interest payments received under secondary market bond insurance purchased by a bondholder.

These three rulings state a favorable result without discussing the rationale. The technical basis for the tax-exemption of bond insurance payments is illuminated in Revenue Ruling 94-42, an adverse ruling involving a bondholder that purchased secondary market bond insurance on zero coupon bonds, rerated the bonds AAA and resold the bonds. The bond insurance premium for the secondary market insurance was an amount sufficient to fund the bond insurer's purchase of a high-yielding portfolio of Treasury securities that economically defeased most of its insurance obligation. In the ruling, the IRS expressed concern that treating such bond insurance interest payments as tax-exempt would effectively permit a secondary market arbitrage bond, and set about distinguishing the scenario under review from "customary" bond insurance payments treated as tax-exempt in the earlier rulings.

In the 1994 ruling, the IRS noted that customarily bond insurance enhances marketability and reduces interest rates, which is consistent with the IRS's objective of preventing overburdening of the market with tax-exempt interest. The ruling stated that such tax-exempt treatment is accomplished by "integrating the insurance contract with the obligation of a political subdivision" instead of treating the bond insurer's obligation as a separate debt instrument.

According to this key ruling, "an insurance contract or similar agreement is treated as both incidental to bonds and not a separate debt instrument … only if, at the time it is purchased, the amount paid is reasonable, customary, and consistent with the reasonable expectation that the issuer of the bonds, rather than the insurer, will pay debt service on the bonds." The ruling concluded that at the time the bond insurance policy under review was purchased, the insurance premium was not reasonable and customary and reflected an expectation of default by the issuer. The IRS ruled that because the insurance purchaser looked primarily to the insurer for payment of the debt service on the bonds, the bond insurance was not incidental and should be treated as a separate non-municipal obligation rather than integrated with the insured bonds. The conclusion that the interest payments by the bond insurer were taxable followed from the treatment of the bond insurance as a non-municipal obligation.

Two significant concepts are articulated in Revenue Ruling 94-42. First, the technical basis for treating bond insurance interest payments as tax-exempt is that, for customary bond insurance transactions, the bond insurance is integrated with and treated as the same debt instrument as the insured municipal bond. Second, the treatment of bond insurance as integrated with the insured bond versus as a separate debt instrument that is not a municipal bond is determined based on reasonable expectations at the time the bond insurance is purchased.

In other words, provided the bond insurance is "customary" at the time it is purchased, it becomes another source of payment by the issuer of the insured bonds, albeit one that, at the time the insurance is purchased, is not expected to be needed. If circumstances change and defaulted interest is paid from the bond insurance, it is deemed a payment by the municipal issuer on the insured bond, not a separate payment by the bond insurer.

Nothing in the revenue rulings on the tax-exemption of interest payments sourced to a bond insurer makes the integration of the bond insurance with the bond dependent on the continuing legal obligation of the issuer to make the insured debt service payment. The above-summarized favorable revenue rulings describe customary bond insurance as including provisions under which a bond insurer's payment to a bondholder does not discharge the bondholder's payment claim against the issuer, to which the insurer becomes subrogated. But such revenue rulings do not suggest that if a bondholder has no claim against the issuer because the issuer has received a bankruptcy discharge, the worthlessness of the bond insurer's subrogation claim alters the character of the bond insurance payment as an integrated tax-exempt payment on the municipal bond constructively made by the issuer, notwithstanding the issuer's discharge as a source of payment for non-tax purposes.

The utility of bond insurance, and the reduction in bond interest rates and the aggregate amount of tax-exempt bond interest that have justified its tax treatment, would be substantially eroded if the IRS were to rule (which it never has) that the tax-exempt nature of bond insurance payments hinges on abstract distinctions between whether non-payment from other sources is due to the issuer's financial condition or to the legal discharge in bankruptcy of the issuer's duty to make such payments. Bond insurance is purchased for the precise purpose of insuring against default by the issuer, foreseeably and prominently including the possibility of the issuer's bankruptcy and the potential legal discharge of part or all of its legal obligation to pay debt service.

The cause of non-payment of the bonds from sources other than the bond insurance is immaterial for tax-exemption purposes once the bond insurance payment is recognized as integrated with and indistinguishable from the other sources of payment of the bond. Moreover, the line between an issuer's lack of a legal obligation to pay and factual insolvency is often vague, and if such a distinction affected tax-exemption of bond insurer payments, uncertainty would prevail. For example, a conduit bond issuer whose obligation to pay is limited to loan or lease payments from a conduit obligor that is not making any payments could be characterized as lacking a legal obligation to pay and/or the financial ability to pay. Similarly, an issuer that ceases to operate and is dissolved without assumption of its liabilities by another party could be characterized as legally non-existent and/or factually unable to pay.

The tax treatment of bond insurance should not, and the relevant revenue rulings support the view that it does not, depend on distinctions that are esoteric, unpredictable and impractical. Notably, in a slightly different context, the market does not doubt the continued tax-exemption of interest on innumerable "legally defeased" bonds payable solely from portfolios of Treasury securities, although the issuer is contractually discharged from making payments from other sources.

The tax impact of bankruptcy plan modifications of an issuer's rights and duties on insured bonds are often an afterthought not adequately focused on in the plan or the plan disclosure. Documentation and characterizations of what is technically occurring to the insured bonds under the plan may be imprecise. A bankruptcy plan may suggest that portions of insured bonds that the issuer will be discharged from paying are being extinguished, when what is actually meant is that such bonds will remain outstanding and payable from bond insurance that for tax purposes is attributed as an issuer payment.

To be sure, some bankruptcy plans may purport to make changes to insured bonds beyond the full or partial discharge of the issuer's liability. Presumptively, a modification of the issuer's contractual duties under a bankruptcy plan does not change the payment obligations insured by the bond insurer. Nonetheless, to avoid muddying the waters plan language should be crafted in a manner that ensures that any portion of the original insured bond from which the issuer is discharged remains outstanding for tax purposes as well as for purposes of claiming against the bond insurer.

Any purported changes by a bankruptcy plan to the terms of the bonds beyond a reduction or elimination of the issuer's liability require separate tax analysis. The devil is frequently in the details, and the debtor and its representatives may not be focused on or impacted by the tax treatment of insured future bond payments from which the issuer has been discharged. Holders of insured tax-exempt bonds that are being modified in any manner by a bankruptcy plan may wish to obtain input from tax counsel experienced in bankruptcy-related tax-exemption issues in time to impact the plan wording and structure relating to such bonds. But, although the IRS has not directly addressed the topic, there is no reason to presume that interest paid by a bond insurer on an outstanding municipal bond will be taxable simply because the issuer will have no remaining legal obligation to make the insured payment from another source.

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