[Bond Case Briefs]

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[Off-Key BABs: IRS Hits Wrong Note in Reissuance Analysis - Mintz Levin]

The IRS recently published a December 9, 2014 Chief Counsel Advice Memorandum to the effect that the defeasance of taxable Build America Bonds (BABs) causes a tax reissuance of the bonds, with the consequence that the municipal issuer ceases to be eligible for federal government interest subsidies for the period from the defeasance date to the redemption date. (A "reissuance" means that from a tax perspective existing bonds are deemed exchanged for new bonds issued on the reissuance date.) The BABs subsidy was available for bonds issued in 2009 and 2010; bonds issued or deemed issued in 2014 are ineligible.

This internal counsel advice is not particularly consequential in the specific context to which it applies. As noted in a Bond Buyer article on the advice memorandum, defeasance escrows for taxable bonds tend to be established for short periods, usually the thirty day period between the date a redemption notice is mailed and the redemption date. Accordingly, any loss of BABs subsidy to the issuer resulting from a purported reissuance is minor. Similarly, though a reissuance of taxable bonds may accelerate realization of gain or loss by a bondholder, if the reissuance occurs 30 days before the redemption date, it is unlikely to change the tax year in which such gain or loss occurs.

The larger point is that the advice memorandum reflects a troubling approach by the IRS to the interpretation of its rules. A legal defeasance of taxable bonds generally causes a reissuance (which is why taxable bond indentures provide for "covenant defeasance", which permits the creation of a defeasance escrow that economically defeases the bonds while the issuer retains theoretical liability for any escrow shortfall.) However, the reissuance regulations provide an exception for municipal bonds. The reissuance exception applies to "tax-exempt bonds", which IRS Regulation 1.1001-3(f)(5)(iii) defines as "a state or local bond that satisfies the requirements of § 103(a)." Section 103(a) of the Internal Revenue Code sets forth the requirements that must be satisfied by tax-exempt municipal bonds.

BABs are required to meet the requirements of Section 103(a) in order to be eligible for the federal subsidy. This is because the BABs subsidy, which is paid by the Treasury to the issuer and offsets the issuer's interest cost, is merely an alternative mechanism for lowering the interest costs to a municipal issuer of issuing bonds that satisfy the criteria for a federal subsidy. Instead of exempting the bondholder from income tax on the bond interest, thereby lowering the rate the issuer must pay to attract bond purchasers, the BABs mechanism pays a subsidy directly to the issuer, which some believe to be a more cost-effective form of federal subsidy. But in order to be eligible for either form of subsidy – tax-exemption of interest, or direct subsidy payments to the issuer by the federal government – the applicable bonds must comply with the same Section 103(a) requirements.

So why does the IRS advice memorandum conclude that the reissuance exception for defeasance of bonds that satisfy the requirements of Section 103(a) is inapplicable to BABs? The memorandum acknowledges that the legislation creating BABs was enacted subsequent to the promulgation of the relevant reissuance exception, and that the regulatory exception was not revised at that time to exclude BABs from the exception. But the memorandum asserts that the concerns that gave rise to the reissuance exception for such defeasances focused on preserving the tax-exemption of interest to bondholders, and that taxable BABs do not present the same concerns for bondholders. Respected bond counsel dispute the advice memorandum's characterization of the regulatory history of the reissuance exception.

But the more troubling feature of the IRS analysis is that BABs satisfy the literal requirements of the reissuance exception for defeasance. Regulatory history and speculation as to whether the rulemakers would or wouldn't have included BABs if they had focused on the question should only be relevant if there is ambiguity in the regulation. In this instance, there is none.

Issuers should be entitled to rely on the plain meaning of IRS regulations in structuring their bond issues and/or refinancing their bond issues. If circumstances change and the IRS does not wish a rule that literally applies to such changed circumstances to be applicable, the burden should be on the IRS to change the rule, versus expecting issuers and practitioners to pre-clear with the IRS whether some unwritten carveout to the rule exists in the minds of individuals at the IRS. A more famous (and tonally adept) Babs once sang "If You Could Read My Mind," but that is no way to run a tax system.

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December 30th, 2014