Bond Case Briefs

Municipal Finance Law Since 1971

Squire Patton Boggs: Crossover Refunding - Does It Really Have to Come to This?

Suppose you, or a friend, issued build America bonds or another form of direct payment subsidy bonds in 2009 or 2010, as permitted by the American Recovery and Reinvestment Act, to do your bit to stimulate aggregate demand during the depths of the Great Recession. You, or your friend, as applicable, did not, however, include an extraordinary optional call feature in the BABs that would allow for the immediate redemption of the BABs if the direct payment subsidy was reduced. Consequently, you've been suffering with the reductions to the direct payment subsidy mandated by sequestration (and that will continue through fiscal year 2024), which have increased the net cost of your BABs.

You would like to advance refund your BABs to replace them with (historically) low-coupon tax-exempt bonds, but you know that the Internal Revenue Service has taken the position that a legal defeasance of tax-advantaged bonds, such as BABs, results in the reissuance for federal tax purposes of those bonds as taxable bonds that are no longer entitled to a direct payment subsidy (even one reduced by sequestration). Under this position, the BABs would lose their direct pay subsidy long before they are called in an advance refunding, a result that's best avoided. Is there anything that can be done in this seemingly hopeless situation?

Crossover Refunding – Back to the Future?

Pretty much nothing from the 1980s, including, but not limited to, mullets, Members Only jackets, and the Laffer Curve, should be revived. But a limited number of items, such as Paul's Boutique, the Super Bowl Shuffle, and the television program ALF, are long overdue for a reprise. Into the latter category falls the technique of a crossover refunding, a tax-exempt financing concept from that era, which could prove useful to an issuer of BABs where the BABs lack an extraordinary optional redemption feature and cannot (at least at this point) be currently refunded.

A crossover refunding differs from a traditional advance refunding in that proceeds of the refunding issue are used to pay interest on the refunding bonds, rather than the refunded bonds, until the call date of the refunded bonds, at which point the balance of the refunding bond proceeds in the refunding escrow are applied toward the repayment of the refunded bonds. Under Treas. Reg. § 1.148-10(c)(4), the crossover advance refunding bonds will not be treated as taxable arbitrage bonds. Moreover, under Treas. Reg. §1.149(g)-1, the crossover refunding should not be treated as comprised of taxable hedge bonds if the refunding results in debt service savings (taking into account the direct payment subsidy on the refunded BABs) or relieves the issuer of significantly burdensome document provisions.

The allure of a valid crossover advance refunding to an issuer of BABs that are not subject to extraordinary optional redemption is that the crossover refunding does not effect a legal defeasance of the BABs for purposes of Treas. Reg. § 1.1001-3(e)(5)(ii)(A). Under that provision of the Treasury regulations, the legal defeasance of a debt instrument (other than a "tax-exempt bond" – more on this below) changes the nature of the debt instrument from recourse to nonrecourse, which results in a significant modification of the debt instrument and the treatment of that instrument as reissued for federal tax purposes. For this purpose, Treas. Reg. § 1.1001-3(e)(5)(ii)(A) describes a legal defeasance as a defeasance "in which the issuer is released from all liability to make payments on the [defeased] debt instrument."[1]

As noted above, the IRS has taken the position in Chief Counsel Advice Memorandum Number AM 2014-009 (the "Memo") that the legal defeasance of direct payment subsidy obligations, such as BABs, results in the reissuance of those obligations for federal tax purposes as obligations that are no longer entitled to the direct payment subsidy. A crossover advance refunding would not, however, result in the legal defeasance of the defeased BABs, because the issuer would remain liable for the payment of debt service on the BABs until their call date. In the absence of a legal defeasance, the BABs should not be treated as reissued for federal tax purposes upon the issuance of the crossover advance refunding bonds, and the issuer should retain the benefit of the direct payment subsidy (as reduced by sequestration) on the BABs until their call date.

Should a Crossover Refunding Really Be Necessary?

The IRS reached its conclusion in the Memo by determining that BABs are not "tax-exempt bonds" within the meaning of Treas. Reg. § 1.1001-3(f)(5)(iii), which defines a tax-exempt bond as "a state or local bond that satisfies the requirements of [Internal Revenue Code] section 103(a)." Under Treas. Reg. § 1.1001-3(e)(5)(ii)(B), the defeasance of a tax-exempt bond does not result in a significant modification of the bond and therefore does not cause the reissuance of the bond for federal tax purposes.

Under Internal Revenue Code section 54AA(d)(1)(A), a bond cannot be a BAB unless that bond satisfies the requirements of Internal Revenue Code section 103. How then does the IRS justify a position in the Memo that is contrary to the plain wording of its own Treasury regulation? By citing the preamble of the Treasury Decision that promulgated the definition of "tax-exempt bond" for purposes of the reissuance regulations. As we have previously discussed, the IRS's citation to the preamble is flawed, but it is also unavailing where the language of the Treasury regulation in question is unambiguous. As the Tax Court held in *Woods Investment Company v. Commissioner*, 85 T.C. 274 (1985), the IRS's remedy if it disagrees with the clear language of a Treasury regulation that it has promulgated is to amend the regulation – not to enforce a position that is contrary to the express provisions of the regulation.

In light of this, there's no reason to fire up the flux capacitor to bring a crossover refunding from the 1980s to the present day, because the legal or economic defeasance of BABs simply should not result in their reissuance for federal tax purposes.

Sequestration – Does it Result in the Repudiation of Debt Owed by the Federal Government?

The question of whether BABs are tax-exempt bonds for purposes of the reissuance regulations arises because of the application of sequestration to the direct payment subsidies paid by the federal Treasury in respect of tax-advantaged bonds, such as BABs.

The effect of sequestration is to adopt mandatory reductions in items of discretionary spending that are subject to annual appropriation if expenditure levels exceed specified thresholds. The direct payment subsidy on tax-advantaged bonds is treated for federal tax purposes as the refund of an overpayment of tax (see IRS Notice 2009-26, Section 3.3, for discussion). The refund of a tax overpayment is not subject to annual appropriation – it is the repayment (albeit without interest) of a debt owed by the federal government to the taxpayer. If the refund is not paid in the full amount owed to the taxpayer, there has been a repudiation of some portion of the debt owed by the federal government to the taxpayer. Is the federal government therefore repudiating a portion of its debt by subjecting to sequestration the direct payment subsidies owed on tax-advantaged bonds?

We'll leave that as a rhetorical question for the time being.

[1] A legal defeasance is illustrated in Treas. Reg. § 1.1001-2(d), ex. 6, as the placement in trust "of government securities that provide interest and principal payments sufficient to satisfy all scheduled payments on the bond." The example concludes that such a defeasance is a modification of the defeased bonds for purposes of the reissuance regulations.

Squire Patton Boggs

The Public Finance Tax Blog

by Michael A. Cullers

USA April 6 2016