Bond Case Briefs

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Try These Weird Tricks to Split a Bond Issue Into Separate Portions: Squire Patton Boggs

Many of the tax-exempt bond rules apply to an "issue" of bonds. With a few exceptions, an issue of bonds includes all bonds sold by an issuer less than 15 days apart under the same plan of financing, if the debt service on those bonds is reasonably expected to be paid from the same source of funds. If an issuer wants to keep two sets of bonds separate, the usual technique is to sell them 15 days apart. But this can expose the bonds to market movements. Where an issuer does not want to take these risks, if bonds are treated as part of the same issue under this rule, what can be done to separate them?

Issuers may want to divide a bond issue into separate portions for many reasons. The most frequently encountered reason is to allow issuers to divide an issue into bonds that have been part of an advance refunding and bonds that haven't, to simplify how the one-advance-refunding rule applies to the issue and allow the issuer to advance refund complete maturities or complete portions of maturities, as opposed to advance refunding only a portion of all of the maturities.

Issuers can use several techniques by themselves or in combination to separate an issue into separate portions for many, if not all, purposes.

First, two important notes:

1. **Designating the bonds as separate series ("Series A" and "Series B") is neither necessary nor sufficient to separate a bond issue into separate portions for tax purposes.** Giving separate names to the separate series will help everyone track the separate purposes, and will make it easier for everyone to explain the separate purposes to people (like an IRS agent) who take an interest in the bond issue after it is issued. But the tax law – not the series designation – governs whether or not an issuer can separate the bonds of the issue into different portions.
2. We're **not** talking about the question of "allocating" different sources of funds to various expenditures for a bond-financed project. Different question, different rules, different consequences.

Separate Issue Treatment under Reg. 1.150-1(c)(3). The first technique for separating an issue of bonds is contained in Reg. 1.150-1(c)(3) (incidentally the same subsection of the regulations that defines an "issue" of bonds in the first place). The issuer can allocate bonds, proceeds, and investments to "separate purposes" of the issue, which means separate loans to conduit borrowers, refunding separate prior issues, truly separate capital projects, etc. This allocation must be made in writing on or before the issue date. (One common reason to make the separate issue election under Reg. 1.150-1(c)(3) is to facilitate compliance with the $150 million nonhospital bond limitation imposed on qualified 501(c)(3) bonds.)

Unfortunately, the Reg. 1.150-1(c)(3) election does not apply for purposes of many of the big-ticket tax-exempt bond requirements. Specifically, it does not apply for purposes of the private business use rules, the arbitrage yield restriction and rebate rules, the advance refunding rules, the rules in Code Section 144(a) regarding small issue industrial development bonds, and the hedge bond rules. For those purposes, we use another technique.

Multipurpose Issue Allocation. If an issuer needs to separate an issue of bonds into separate purposes for certain arbitrage purposes (or, more often, for purposes of the one-advance-refunding rules), then the issuer can allocate those bonds (and their proceeds and investments of those proceeds) under the terms of Reg. 1.148-9. These rules allow an issuer to split the issue into separate portions for almost all purposes of the arbitrage rules, except for calculating the yield on the bonds (with limited exceptions), calculating the rebate amount, determining the minor portion and determining the portion of the issue eligible for investment in investments that can earn arbitrage as part of a reserve fund. The separate portions must, as in the technique under Reg. 1.150-1(c)(3), correspond to truly separate purposes of the issue. The most common example is separating an issue into new money and refunding portions (typically with a separate refunding portion for each refunded prior issue), but an issuer can further subdivide the new money portion of an issue into separate new money portions if, generally, the new money projects financed are not integrated or functionally related. The multipurpose issue allocation rules generally apply for purposes of the private business use rules (see Reg. 1.141-13(d) and Reg. 1.141-13(g), Example 5) and, most importantly, the one advance refunding rule (see Reg. 1.149(d)-1).

Unlike the election under Reg. 1.150-1(c)(3), a multipurpose issue allocation "may be made at any time, but once made may not be changed." Reg. 1.148-9(h)(2)(i). But, the rule always applies, although it has no effect until the issuer/borrower makes the allocation. This is why you will often see language regarding the multipurpose issue allocation in a tax certificate that says something to the effect of "no allocation is being made at this time, but at the future option of the issuer, the issuer can make an allocation according to [x]."

Special rules apply to the refunding portion of the issue. If an issuer wants to specify certain bonds of the issue as the refunding bonds (and avoid a pro rata piece of each bond being treated as a refunding bond), then those bonds must meet one of the following requirements. First, the refunding portion must reflect aggregate debt service that is "less than, equal to, or proportionate to" the debt service on the prior issue in each bond year. This is often called the "debt service savings" test, although, as the quoted language shows, you don't have to show savings. The rationale for this requirement is not abundantly clear from the regulations or their history, but it appears to be that refunding bonds are usually issued to capture debt service savings, and, "if it looks like a duck and sounds like a duck," then it must be a duck/refunding bond.

If the "debt service savings" test cannot be met, then an issuer can specify certain bonds as the refunding bonds if the weighted average maturity of the refunding bonds has the same ratio to the remaining economic life of the refunded assets as the ratio of the weighted average maturity of the new money bonds has to the remaining economic life of the new money assets. (As you can tell from reading the previous sentence, it's difficult to rely on this test, and it's basically impossible to meet this requirement by happenstance.) Finally, if the bonds that the issuer wants to specify as the refunding bonds can't meet either of these tests, the issuer must be able to show that it cannot meet these tests because of a state law prohibition or that the bonds were issued under certain old indentures; not that it will likely matter, but the regulations say that this one is "strictly construed." Failing that, the issuer is stuck with the conclusion that each group of substantially identical bonds (for example, bonds having the same maturity date) has a pro rata flavor swirl of the various portions of the issue. A number of other detailed rules apply to figure out the precise amount of proceeds allocated to each of the portions and to allocate common costs of the various portions among the portions.

To emphasize again, when an issuer wants to separate a bond issue into various portions, the issuer must meet the above requirements, whether or not it designates the refunding bonds as a separate series for securities purposes.

Other separation techniques exist. For example, an issuer of bonds to finance facilities that will be used in part by governmental entities and in part by 501(c)(3) organizations that are technically part of a single issue can treat them as separate issues of governmental use bonds and 501(c)(3) bonds if the separate portions, treated as separate issues, satisfy the tax-exempt bond requirements separately. The Conference Report for the Tax Reform Act of 1986 states that “the conferees intend that, where an issue consists of two components – governmental financing and qualified 501(c)(3) financing – and the two components, **viewed as separate issues**, satisfy all requirements for tax-exemption. . . .” Conf. Rpt. 99-841, at II-726. (Emphasis added.)

Below is a diagram to illustrate how some of these rules overlap, using a simple example of an issue of bonds that an issuer wants to separate into a new money portion and a refunding portion.

Click here to view the image.

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