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IRS Releases Proposed Regulations Consolidating Guidance on Reissuance of Tax-Exempt Bonds: Mintz, Levin

On December 31, 2018, the Department of Treasury and Internal Revenue Service released long-awaited proposed regulations (the “Proposed Regulations”) that address when modifications to the terms of tax-exempt bonds are treated as an exchange of existing bonds for newly issued (or “reissued”) bonds for purposes of section 103 and sections 141 through 150 of the Internal Revenue Code and when an issuer’s acquisition of its bonds results in such bonds ceasing to be outstanding for federal tax purposes. The Proposed Regulations (found at <https://www.govinfo.gov/content/pkg/FR-2018-12-31/pdf/2018-28370.pdf>) are intended to unify and clarify existing guidance.

Background

If, after tax-exempt bonds are issued, an issuer and bondholder agree to significantly modify the terms of the bonds, the original bonds may be treated for federal tax purposes as having been exchanged for newly issued modified bonds. Additionally, if an issuer or its agent acquires and resells a bond, the bond may be treated as having been retired upon acquisition and replaced with a newly issued bond upon resale. The replacement of the old bond with the newly issued bond is commonly referred to as a “reissuance”. Reissuance of a bond is significant because it is treated as a current refunding for tax purposes and the continued tax-exemption of the bond after the reissuance date must be reassessed by reference to tax law requirements and factual circumstances in effect as of the reissuance date. In addition, a reissuance may result in the realization of tax loss or gain as of the reissuance date by the holder of the reissued bond.

Tender option bonds and variable rate demand bonds have certain characteristics that raise reissuance questions. The Proposed Regulations are expected to replace existing guidance in Notice 88-130 and Notice 2008-41 related to tender option bonds and variable rate demand bonds and to conform Treasury Regulations Section 1.1001-3, which generally governs modifications to debt instruments, to the special rules in the Proposed Regulations.

Proposed General Rules for Retirement of Tax-Exempt Bonds

Under the Proposed Regulations, a tax-exempt bond is treated as retired (i.e., no longer outstanding for federal tax purposes) if a significant modification occurs under Regulations Section 1.1001-3, if the issuer or an agent acquires the bond in a manner that liquidates or extinguishes the holder’s investment in the bond, or if the bond is otherwise redeemed (for example, paid at maturity or upon an optional or mandatory redemption). Notably, under the Proposed Regulations, “issuer” is defined to mean the actual issuer of the bonds or any related party rather than the conduit borrower. This means that acquisition of a bond by a conduit borrower would not result in the retirement of that bond.

Exceptions to the General Rules

The Proposed Regulations provide three exceptions to the general rules. The first two exceptions

relate to “qualified tender bonds” and the third applies to all tax-exempt bonds. A “qualified tender bond” is defined as a tax-exempt bond that (i) bears interest during each authorized interest rate mode at a fixed interest rate, a qualified floating rate or an objective rate, (ii) bears interest unconditionally payable at periodic intervals of no more than one year, (iii) has a stated maturity date that is not later than 40 years after the issue date of the bond, and (iv) includes a qualified tender right. A “qualified tender right” is defined as the right or obligation of a holder of the bond to tender the bond for purchase that (i) is available on at least one date before the stated maturity date, (ii) has a purchase price equal to par plus any accrued interest, and (iii) is followed by the issuer or remarketing agent either redeeming the bond or using reasonable efforts to resell the bond within 90-days from the date of tender for a purchase price of par plus any accrued interest.

Under the first exception in the Proposed Regulations, both the existence and exercise of a qualified tender right are disregarded when applying Regulations Section 1.1001-3 to a qualified tender bond. Accordingly, an interest rate mode change that occurs pursuant to the terms of a qualified tender bond does not cause the bond to be reissued because the qualified tender right is ignored and the issuer’s election to change the interest rate mode is considered the exercise of a unilateral option, which under Regulations Section 1.1001-3 is not treated as a modification.

Under the second exception in the Proposed Regulations, the acquisition of a qualified tender bond by the issuer or its agent does not result in retirement of the bond if the acquisition is pursuant to the operation of a qualified tender right and the bond is not held by the issuer or its agent for more than 90 days after the date of tender. In other words, if a qualified tender bond is tendered to an issuer, the issuer or its agent can hold the bond for up to 90 days before remarketing it without causing a reissuance of the bond. As noted above, a conduit borrower or its agent can hold such a bond indefinitely before remarketing without causing a reissuance.

The third exception under the Proposed Regulations applies to all tax-exempt bonds, not just qualified tender bonds. Under this exception, the acquisition of a tax-exempt bond by a guarantor or liquidity facility provider acting on the issuer’s behalf but unrelated to the issuer does not result in retirement of the bond if the acquisition is pursuant to the terms of the guarantee or liquidity facility.

Consequences of Retirement

If a bond is treated as retired pursuant to the Proposed Regulations due to a deemed exchange, the modified bond is treated as a new bond issued in exchange for the original bond. If a bond is treated as retired pursuant to the Proposed Regulations following the acquisition of the bond by the issuer or its agent, (i) if the issuer resells the bond, the bond is treated as a new bond issued on the date of resale, or (ii) if the issuer does not resell the bond, it simply ceases to be outstanding for federal tax purposes. If the bond is treated as a newly issued bond, it will generally be treated as a current refunding bond which must be retested for qualification as a tax-exempt bond under sections 103 and 141 through 150 of the Internal Revenue Code. Potential negative consequences for the issuer include a change in yield for purposes of arbitrage and rebate, acceleration of any required rebate calculation and payment and change-in-law risk.

Optional Application

The Proposed Regulations will be effective 90 days after they are published (following comments and any revisions) as final regulations in the Federal Register but they may be applied to events and actions taken with respect to tax-exempt bonds that occur before that date.

Comments and requests for a public hearing must be received by March 1, 2018.

by Christie L. Martin

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