IRS Aids State and Local Governments With Tax-Exempt Tender Bonds and Commercial Paper: McGuire Woods

State and local governments frequently finance capital projects such as airports and utility systems by issuing tax-exempt qualified tender bonds (also commonly called variable rate demand obligations or "lower-floaters") and commercial paper. These obligations give the issuer the benefits of long-term financing with short-term interest rates.

However, tender bonds and commercial paper are variable-rate obligations. This exposes issuers to higher interest rates in times of market dislocation.

During the week of March 9, 2020, the extent of the COVID-19 outbreak was becoming apparent. The World Health Organization declared the outbreak a pandemic, President Trump declared a national emergency and many state governors declared states of emergency. Investors fled tender bonds and commercial paper. Over the course of the following week, the rates on these obligations increased fourfold.

State and local governmental issuers often seek to lessen the budgetary blow from spiking interest rates by purchasing their own tender bonds and commercial paper and holding them until the markets return to normal.

An issuer with sufficient liquidity may find a temporary purchase and hold strategy to be attractive. However, it is fraught with federal tax issues. A debt obligation generally is treated as retired or extinguished when an issuer purchases it because the interests of the issuer and the holder merge. The ability to resell the obligation on a tax-exempt basis requires the retesting of all the various program requirements for new issues of tax-exempt bonds. The reissuance of the debt obligation may result in various negative consequences to the issuer, including changes in yield for purposes of the arbitrage investment restrictions, acceleration of arbitrage rebate payment obligations, deemed terminations of integrated interest rate swaps under the qualified hedge arbitrage rules, new public approval requirements for qualified private activity bonds, and change in law risk. The obligation may lose its tax-exempt status.

Fortunately, the IRS has provided administrative relief to promote liquidity and stability in the tax-exempt tender bond and commercial paper markets in response to the COVID-19 pandemic.

On May 4, 2020, the IRS published Revenue Procedure 2020-25 to expand existing authority for state and local governmental issuers to purchase their own tender bonds and commercial paper on a temporary basis without causing a reissuance or retirement. To qualify, the issuer must purchase the bonds or paper during calendar year 2020 and not hold the debt after Dec. 31, 2020. The revenue procedure affords additional relief for purchases of tender bonds pursuant to qualified tender rights. The issuer may hold such a bond for 180 days after the purchase (instead of the usual 90 days) so long as the purchase occurs before Dec. 31, 2020.

Revenue Procedure 2020-25 allows the issuer to refund its purchased obligation with a tax-exempt refunding bond, to tender the purchased obligation for purchase pursuant to a qualified tender right the same as any other bondholder, or otherwise to sell the purchased obligation during the permitted holding period without jeopardizing its tax-exempt status.

Note: State and local governments often issue tender bonds and commercial paper to finance projects for non-governmental conduit borrowers. Examples include an economic development authority issuing tax-exempt tender bonds and lending the proceeds to the private operator of a solid waste disposal facility or the 501(c)(3) owner of a hospital. Also, tender bonds are often secured by a third-party credit and/or liquidity provider, such as a commercial bank. Conduit borrowers and credit and liquidity providers are generally allowed to purchase, hold and resell the tax-exempt tender bonds and commercial paper from which they benefit or secure without regard to any permitted holding period.

McGuireWoods has established a COVID-19 Response Team to help clients navigate urgent and evolving legal and business issues arising from the novel coronavirus pandemic. Lawyers in the firm's 21 offices are ready to assist quickly on questions involving healthcare, labor and employment, education, real estate and more. For assistance, contact a team member or email covid-19@mcguirewoods.com.

McGuireWoods has published additional thought leadership analyzing how companies across industries can address crucial business and legal issues related to COVID-19.

May 12, 2020