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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Mary Oppenheimer
Assistant Chief Counsel CC:TEGE:EOEG:TEB

SUBJECT: Reissuance of Tax-Exempt Bonds

This Field Service Advice responds to your memorandum dated September 7, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND

Issuer =

Act	=
State	=
Year 1 Bonds	=
Refunding Bonds	=
Trustee 1	=
Trustee 2	=
Corporation	=
Underwriters	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
$a	=
b	=
$c	=
$d	=
e	=
$f	=
$g	=
$h	=
$i	=
$j	=
$k	=
$l	=
$m	=
$n	=
$p	=
$q	=
$r	=

s =
t =
$u =
$v =
$w =

ISSUE

Whether the financial benefit an issuer of tax-exempt bonds received, including payments from a bondholder, in connection with alterations the issuer made to the terms of such bonds results in a reissuance of the bonds.

CONCLUSION

Taking into account the alterations that were made to the terms of the bonds, the issuer's financial benefit, and the payments the issuer received from a bondholder in connection with such alterations, there was a reissuance of the bonds.

FACTS

The Issuer was formed on or about Date 1, under the Act. The Act authorizes the Issuer to issue revenue bonds for the purpose of assisting its member school districts in financing qualifying facilities, services, or improvements. Any school district in State can become a member of the Issuer.

Year 1 Issuance

On Date 2, the Issuer issued its Year 1 Bonds in the amount of $a. The Year 1 Bonds were issued pursuant to a Master Indenture of Trust (the "Master Indenture"), and a Supplemental Indenture of Trust (the "First Supplemental Indenture"), between the Issuer and Trustee 1. The stated purpose of the Year 1 Bonds was to provide a pool of funds for financing projects permitted under the Act (the "Program"). Members borrowing from the pool ("Participating Members") were to enter loan agreements with the Issuer (the "Agreements").

On the date of issuance, the proceeds of the Year 1 Bonds were deposited into the Program Fund created under the Master Indenture. No costs of issuance were paid on the date of issuance; instead, costs of issuance were deferred to the date loans were made from proceeds of the Year 1 Bonds and would be paid proportionately to the amount of loans financed.

Also on Date 1, the Issuer entered into a guaranteed investment contract (the "GIC") with Corporation. The GIC yielded b percent and was funded with the proceeds deposited in the Program Fund. The terms of the GIC included a "no-earlier-than draw schedule" pursuant to which funds could be withdrawn from the GIC to make loans to Participating Members from the date of issuance of the Year 1 Bonds to the expiration date of the GIC on Date 3. Pursuant to the Master Indenture, the provider of the GIC was required to have a rating of no less than "AAA" by Standard & Poor's ("S&P") as of the date of execution.

The Year 1 Bonds are limited obligations of the Issuer payable from (1) payments made by Participating Members under loan agreements with the Issuer, (2) from amounts in the funds created under the Master Indenture, including amounts on deposit in the Program Fund and invested in the GIC, and (3) investment earnings thereon.

The Year 1 Bonds were issued in two maturities: $c in term bonds due Date 4, and $d in term bonds due Date 5. The yield on the Year 1 Bonds, for purposes of I.R.C. § 148, was approximately e percent.

Under the Master Indenture, the Year 1 Bonds are subject to mandatory redemption from principal repayments under any Agreements between the Issuer and Participating Members. If all of the proceeds were converted to loans, there would be no redemption of the Year 1 Bonds until and as the underlying loans were repaid. If none of the proceeds were converted to loans, then there would be a total redemption of the Bonds on Date 3, when the GIC matured.

Further, under the terms of the Master Indenture and the First Supplemental Indenture, the Year 1 Bonds are also subject to redemption by application of sinking account prepayments beginning in Year 3.

Under the Master Indenture, whenever less than all of the bonds of a series of the Year 1 Bonds are to be redeemed, Trustee 1 is required to make the selections by lottery and to mail notice of such selection to the holders no later than thirty days prior to the redemption date.

The GIC matured on Date 3. On that date, $f of the Year 1 Bonds had been previously redeemed pursuant to the mandatory sinking fund redemption provisions. The remaining $g of the Year 1 Bonds were redeemed when the GIC matured. No loans were made to any member school districts from the proceeds of the Year 1 Bonds.

Under the Master Indenture, the rights and obligations of the Issuer and holders of the Year 1 Bonds may be modified by an indenture or supplemental indenture with the written consent of the owners of a majority of the then outstanding bonds. In addition, the Issuer and the Trustee may, without the consent of or notice to any bond holder, enter into any indenture or supplements to the indenture for purposes including the following:

(a) to provide for the issue of a series of bonds and to provide for the rate or rates of interest, maturity, and terms of redemption for such series of bonds;

(b) to add to the covenants of the Issuer in the Master Indenture, to pledge or assign additional security for the Year 1 Bonds, or to surrender any right or power reserved to or conferred upon the Issuers in the Indenture;

(c) to make provisions for the curing of any ambiguity, inconsistency or omission, or of curing or correcting any defective provision in the Master Indenture, or as to any other provisions of the Indenture as the Issuer may deem necessary or desirable, in any case, which does not adversely affect the security for the Year 1 Bonds;

(d) to modify, amend or supplement the Master Indenture in such manner as to cause interest on the Year 1 Bonds to be excludable from gross income for purposes of federal income taxation;

(e) to modify any of the requirements of the Master Indenture having to do with the terms and provisions of any loan agreement between the Issuer and a Participating Member, provided that prior to any such modification, there was filed with the Trustee 1 written evidence that such modification will not result in the reduction or withdrawal of the rating on the Year 1 Bonds.

<u>Year 2 Transactions</u>

According to the Issuer, by Year 2, it recognized that declining interest rates made it unlikely that loans would be made from the proceeds of the Year 1 Bonds.

As represented by the Issuer, the prevailing market conditions impacted the Year 1 Bonds in two ways. First, they traded at a premium because their interest rate was generally higher than the interest rate on recently issued tax-exempt bonds. Second, they traded at a lower price than bonds with the same interest rate, but shorter maturities than their scheduled maturities. That is because an investor, in order to value any of the Year 1 Bonds, would have to assume that he would be able to receive interest on the Bond as scheduled at least until Date 3, and would then take into account (by discounting the price) the fact that approximately 21% of the Date 4 maturity and approximately 12% of the Date 5 maturity would be randomly called for sinking fund redemption prior to Date 3. Because the determination as to which bonds would be redeemed early had not been made, all of the Year 1 Bonds were impacted.

On Date 6, the Issuer directed Trustee 1 to discontinue the use of the book-entry only system and to register the Year 1 Bonds in the individual names of the owners pursuant to the Master Indenture. Prior to this date, the record owner of the Year 1 Bonds had been a nominee holder. New bonds were then signed and sealed by the Issuer and delivered to Trustee 1 for transfer to the beneficial owners.

On or about Date 7, the Issuer removed Trustee 1 as trustee and appointed Trustee 2. Notice of the change was mailed to the registered holders of Year 1 Bonds.

On Date 8, the Underwriter mailed notices of tender offers to the owners of the Year 1 Bonds.

Two days later, on Date 9, Trustee 2 held a lottery to determine which of the Year 1 Bonds would be called on the applicable redemption dates in Year 3 through Year 4. Rather than holding a separate lottery in Year 3 and each subsequent year to determine which bonds would be redeemed in that particular year, Trustee 2 held one lottery in Year 2 to identify the bonds that would be redeemed in each year. All of the Year 1 Bonds were included in the lottery process. The process allocated sinking fund maturities for the Year 1 Bonds from Year 3 through their maturity dates. New CUSIP numbers were assigned to each sinking fund redemption date. The results of the lottery were not immediately provided to the record bondholders, but were immediately reported to the Underwriter.

On Date 10, the Underwriters purchased $h of the outstanding Year 1 Bonds maturing on Date 5, pursuant to their tender offer at a combined price of $i, or at 108.5%.

Also on Date 10, the Issuer issued its Refunding Bonds in the amount of $j. The stated purposes for the issuance of the Refunding Bonds were: 1) advance refunding $j principal amount of the outstanding Year 1 Bonds; 2) financing the Issuer's cost of acquiring and constructing an administration office building; and 3) initially funding a Subsidy Fund to reduce the borrowing costs of member school districts. Only the Year 1 Bonds purchased by the Underwriters were refunded by the Refunding Bonds. The Refunding Bonds were not issued as tax-exempt.

In a memo from the Underwriter to the Issuer prior to the issuance of the Refunding Bonds, the Underwriter describes the "GIC profit" that can be generated with the refunding of the Year 1 Bonds. The Underwriter detailed how the differential in interest rates between the GIC and the Refunding Bonds created a profit opportunity that could be capitalized. The Underwriter proposed that the Refunding Bonds would be structured so that they would not be subject to redemption before the date on which the excess earnings on the GIC would be captured.

The Refunding Bonds were tender option bonds due Date 5. The Refunding Bonds were also issued on Date 10. Proceeds in the amount of $k were used to pay the underwriting fee and other costs of issuance.

On the date of issuance of the Refunding Bonds, $l was deposited into the Administration Building Subaccount of the Construction Fund. In addition, $m was deposited into the Subsidy Fund. The remaining proceeds, $n, were used to fund the advance refunding escrow (the "Refunding Escrow"). The Refunding Escrow fully defeased the Year 1 Bonds purchased by the Underwriters (the "Year 1 Refunded Bonds").

The stated purpose of the Subsidy Fund was to reimburse the Issuer for Program Expenses or to disburse moneys to the Issuer to be used pursuant to the Program Guidelines. The term Program Expenses was defined to include fees and expenses relating to the Refunding Bonds and the Subsidy Fund incurred by Trustee 2 and the Issuer relating to the administration of the Refunding Bonds and financial losses sustained as a result of the liquidation of any securities to make funds available to a Participating Member under an Agreement. The Program Guidelines provided that amounts on deposit in the Subsidy Fund would be used to subsidize members for their issuance costs on other financings. In a memo from the Underwriter to the Issuer prior to the issuance of the Refunding Bonds, the Underwriter explained that the profit generated from refunding the Year 1 Bonds would finance the amounts deposited in the Subsidy Fund and the Construction Fund. The Subsidy Fund was not pledged as security for the Refunding Bonds. In addition, the Refunding Bonds were not secured by a lien on the Issuer's administration building, which was constructed out of the proceeds deposited in the Construction Fund.[1]

Simultaneously with the issuance of the Refunding Bonds, the Issuer adopted its second Supplemental Bond Indenture (the "Second Supplemental Indenture"). The purpose of the Second Supplemental Indenture was to effectuate certain amendments to the Master Indenture.

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[1] The Issuer's representative acknowledged in correspondence that the Issuer received a financial benefit of at least $w, the aggregate of the amounts deposited in the Construction and Subsidy Funds. The representative characterized this benefit as a payment from Bondholders to remove the redemption uncertainty of the Year 1 Bonds.

The amendments to the Master Indenture caused by the Second Supplemental Indenture included: providing that moneys on deposit in the Year 1 Program Fund (and invested in the GIC) could be withdrawn (subject to satisfying current obligations to pay Year 1 Bonds) to make payments on the Refunding Bonds; prohibiting the payment of costs of issuance out of the proceeds of the Year 1 Bonds; and restricting the amount of loans under Agreements with Participating Members to the principal amount of Year 1 Bonds outstanding. With respect to the redemption provisions of the Year 1 Bonds, language was added to the Master Indenture providing that a lottery could be called by the trustee more than 90 days prior to the date set for redemption.

On or about the issue date of the Refunding Bonds, the Underwriters purchased US Treasury Strips to be held in the Refunding Escrow for a combined price of $p. The securities in the Refunding Escrow were sold to the Issuer for $q resulting in a loss to the Underwriters of $r.

The yield on the Refunding Escrow, based on the $q cost of the securities to the Issuer, equals approximately s percent. The yield on the Refunding Escrow, based on the $p cost of the securities to the Underwriters, equaled approximately t percent.

After the issuance of the Refunding Bonds, Trustee 2 was authorized by the Issuer to give notice of the redemption of the Year 1 Bonds, and all the bonds were officially called for redemption pursuant to the sinking fund lottery results. In addition, pursuant to the terms of the Escrow Agreement for the Year 1 Refunded Bonds, the escrow agent was to mail a second notice of sinking account redemption to each registered owner of the Year 1 Refunded Bonds within 31 days of the actual redemption date.

Once the Refunding Bonds were issued, the Underwriter remarketed the Year 1 Refunded Bonds to the public. The Remarketing Memorandum for the Year 1 Refunded Bonds specified the scheduled redemption dates established by the lottery. The Remarketing Memorandum indicated that all the Year 1 Refunded Bonds would be redeemed by Year 4 at the latest.

The Year 1 Refunded Bonds were remarketed for $u, for a profit of $v to the Underwriter. The remarketed bonds were sold pursuant to a new Official Statement. New Year 1 Bond certificates were delivered to a new nominee holder for the benefit of the bondholders. (The holding of the lottery to establish sinking fund redemption dates for the Year 1 Bonds, the Underwriters purchase of Year 1 Bonds, and the subsequent defeasance and remarketing of the Year 1 Bonds are referred to collectively as the “Year 2 Transaction”).

LAW AND ANALYSIS

Section 1001 of the Internal Revenue Code governs for determining when securities received in exchange for securities surrendered in a transaction gives rise to a gain or loss. The standard, under Treas. Reg. § 1.1001-1(a), for determining whether an exchange of property is a disposition is whether the properties exchanged differ materially either in kind or extent.

The modification of a debt instrument constitutes a deemed exchange under section 1001 if the modified debt instrument is materially different from the original debt instrument. Rev. Rul. 89-122, 1989-2 C.B. 200.[2] Where changes in the terms of an outstanding security are so material as to amount virtually to the issuance of a new security, the same income tax consequences should follow as if a new security were actually issued. Rev. Rul. 81-169, 1981-1 C.B. 429. If the modifications constitute a deemed exchange, then the resulting instrument has customarily been treated as newly issued for federal income tax purposes. The receipt of bonds containing materially different terms from those contained in bonds surrendered is a taxable event under section 1001. Id. For purposes of sections 103 and 141 through 150, the consequence of a reissuance of tax-exempt bonds is that the law in effect on the date of the reissuance will apply to the reissued bonds.

With respect to whether such material changes have been, or will be made, each case must be governed by its own facts. Rev. Rul. 73-160, 1973-1 C.B. 365. Moreover, resolution of the question of whether there was a material change does not turn on whether there was a physical exchange. The economic substance of a transaction, rather than its form, governs for tax purposes. Gregory v. Helvering, 293 U.S. 465 (1935). The characterization of a transaction by the parties is not determinative for Federal tax purposes. Paulsen v. Commissioner, 469 U.S. 131 (1985).

Some of the factors that the Service and the courts have considered in determining whether modifications to a debt instrument result in a reissuance include changes to the interest rate or yield, the timing of payments, and the amount of payments. For example, in Rev. Rul. 73-160, the Service determined that the mere extension of the maturity date of notes, accompanied by an agreement of some of the holders not to resort to the underlying security until other holders had been paid, does not constitute, in substance, the exchange of the notes for new and materially different notes. Thus, the change to this one factor

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[2] For alterations of the terms of a debt instrument on or after September 24, 1996, Treas. Reg. § 1.1001-3 addresses when a modification of a debt instrument is deemed to cause an exchange for purposes of section 1.1001-1(a) of the regulations. The provisions of this section may also be relied on for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996. The parties agree that Treas. Reg. § 1.1001-3 is inapplicable here.

was determined to be insufficient for the modification of the note to qualify as a taxable exchange under section 1001. Id.

In contrast, in Rev. Rul. 81-169, a taxpayer owned a municipal bond bearing interest at 9 percent and subject to sinking fund payments. The taxpayer exchanged that bond for a bond of equal face amount bearing interest at 8.5 percent, not subject to a sinking fund provision, and maturing 10 years later. The Service determined that the changes in the terms of the bonds, taken together, were material. Therefore, the exchange was taxable under section 1001.

In Rev. Rul. 87-19, 1987-1 C.B. 249, the Service ruled that a change in the interest rate on a bond that occurred pursuant to the terms of the bond did not trigger a reissuance. In the cited ruling, a taxpayer owned municipal bonds bearing interest at 7 percent that contained an interest adjustment clause that triggered an increase in the interest rate on the bonds in the event of a decrease in the maximum marginal federal corporation income tax rate. Prior to the date the increase would have been triggered, the bondholder waived its rights under the interest adjustment clause. Thus, the bonds continued to bear a 7 percent interest rate rather than 8.56 percent interest rate that would have resulted under the interest adjustment clause.

In its ruling, the Service concluded that an adjustment to the interest rate on an issue of bonds pursuant to an interest adjustment clause does not result in an exchange. Although the interest payable on the bonds changes as a result of the adjustment, the adjustment is fixed by the terms of the bonds upon issuance. However, the waiver of the adjustment was a material change in the terms of the bonds, resulting in a deemed reissuance. Id.

In Rev. Rul. 89-122, a debt instrument issued by a bank was modified in two different situations. In Situation 1, the interest rate was reduced from 10 percent to 6.25 percent, but the principal amount of $1,000,000 remained unchanged. In Situation 2, the stated principal amount was reduced from $1,000,000 to $650,000. The Service stated that, "In general, the modification of a debt instrument constitutes a deemed exchange of debt instruments under I.R.C. section 1001 if the modified debt instrument is materially different from the original debt instrument." Both modifications represented a material change in the terms of the obligations and resulted in a deemed exchange of the instruments.

A change in the yield of a debt instrument, as opposed to a change in the nominal interest rate, is also a relevant factor in determining whether a reissuance occurs. In Girard Trust v. Commissioner, 166 F.2d 773 (3d Cir. 1948), the taxpayer surrendered City of Philadelphia bonds pursuant to a City of Philadelphia refunding plan. In exchange, the taxpayer received new bonds with an earlier maturity date and a later optional maturity date than the old bonds. The new bonds had the same interest rate until the maturity date of the old bonds and a lower interest rate thereafter. The new bonds also had a higher fair market value. The court determined that these were important basic differences between the old and the new bonds. In addition, the court stated that the "difference in yield [on the obligations] was not inconsequential." Id. at 774. As a result, the court affirmed the lower court's finding that the exchange was taxable.

The question of what constitutes a "material difference" for purposes of section 1001 of the Code was addressed by the Supreme Court in an opinion issued prior to the 1991 transaction in issue. In Cottage Savings Assn. v. Commissioner, 499 U.S. 554 (1991), the Court held that the taxpayer, a savings and loan association, realized a deductible loss in 1980 when it exchanged a 90% participation interest in a pool of residential mortgage loans for an unrelated thrift's similar interest in a pool of its residential mortgage loans. The mortgages in each pool had similar financial features (interest rates, terms to maturity, etc.) and were secured by homes located within the same state.

The Court in Cottage Savings applied the materially different requirement set forth in Treas. Reg. § 1.1001-1(a). The Court also looked to case law to give meaning to the material difference test, and determined that property exchanged for other property was materially different as long as the exchanged properties "embody legally distinct entitlements." Id. at 566. This standard may be met where the property entitlements are not identical, thus allowing both the Commissioner and the transacting taxpayer to easily fix the appreciated or depreciated values of the property relative to their tax bases. Id. at 565. The Court determined that the taxpayer received entitlements that were materially different from those that it gave up because the participation interests that it received were made to different obligors and were secured by different homes. Therefore, the transaction was taxable and the taxpayer realized a loss on the exchange. The interests that were exchanged were considered "substantially identical" for federal banking regulatory purposes, but that fact did not affect the tax treatment of the exchanged instruments. Id.

In the instant case, the Issuer asserts that the Year 2 Transaction was designed to eliminate the uncertainty regarding the redemption dates of the Year 1 Bonds. By determining in a Year 2 lottery precisely which bonds would be redeemed earlier under the sinking fund provisions and assuring holders that the Year 1 Bonds would be called in Year 4, the parties to the Year 2 Transaction were able to enhance the market value of the Year 1 Bonds. This, coupled with the defeasance of the Year 1 Refunded Bonds, enabled the Underwriters to remarket a portion of the Year 1 Bonds at a significant premium.

The Issuer contends that the alterations to the Year 1 Bonds made in connection with the Year 2 Transaction were legally insignificant and did not alter the rights or obligations of either the Issuer or the Bondholders. In addition, it asserts that modifications to the Master Indenture in Year 2 merely clarified rights it already possessed under the original documents. For example, establishing the sinking fund maturity dates for all the Year 1 Bonds in Year 2, the Issuer maintains, was merely an exercise of a unilateral right it purportedly held under the original Master Indenture. In support of its argument, the Issuer points to the fact that it did not obtain Bondholder consent prior to amending the Bond documents or holding the early lottery.

Despite the Issuer's assertions, whether the changes to the Year 1 Bonds made in Year 2 were preauthorized by the Master Indenture is not determinative under the current facts. Rather, the question of whether the modifications resulted in a reissuance must be based on a realistic view of the overall Year 2 Transaction, considering each of the interrelated steps that have legal or economic significance.[3]

It is incontrovertible that the Issuer obtained a financial benefit from its participation in the Year 2 Transaction. Regardless of whether the early lottery was authorized by the Bond documents, the lottery was held in connection with the Underwriter's tender offer for the Year 1 Bonds. The parties concede that the lottery enhanced the value of all the Year 1 Bonds, including those purchased by the Underwriter. However, the results of the lottery were not immediately provided to the record Bondholders, but were reported to the Underwriter. Simultaneously with the Underwriter's purchase of the Year 1 Bonds, the Issuer issued its Refunding Bonds, the proceeds of which were used to defease the Year 1 Refunded Bonds. Each of these steps enabled the remarketing of the Year 1 Refunded Bonds for $u, a profit of $v to the Underwriter. The evidence shows that

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[3] Evaluating the facts and circumstances of a transaction is also consistent with the approach applied in the current regulations. Under Treas. Reg. § 1.1001-3(b), a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. Paragraphs (e)(2) through (6) of Treas. Reg. § 1.1001-3 provide specific rules for determining the significance of certain types of modifications. However, Treas. Reg. § 1.1001-3(e)(1) provides the general rule that, except as otherwise provided in paragraphs (e)(2) through (e)(6), a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. In making a determination, all modifications to the debt instrument (other than modifications subject to paragraphs (e)(2) through (6) of this section) are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.

$r of this profit was passed on to the Issuer through the discounting of the Refunding Escrow securities. The Issuer's representative has stated that this amount was paid as reasonable compensation to the Issuer for undertaking to defease $h of the Year 1 Bonds.

In addition to the benefit obtained from the below market sale of the Refunding Escrow securities, the Issuer acknowledges that it received an additional sum at the time of the issuance of the Refunding Bonds in the amount of $w. This amount is the aggregate of the amounts deposited in the Construction Fund and Subsidy Fund and was referred to in a memorandum from the Underwriter to the Issuer describing the "GIC profit" that resulted from the differential in interest rates and how that profit could be realized by refunding a portion of the Year 1 Bonds. Moreover, correspondence from the Issuer's representative characterizes the financial benefit received by the Issuer as payment from Bondholders to remove the redemption uncertainty of the Year 1 Bonds.

In attempting to separate the actions of the Issuer in connection with those of the Underwriters, the Issuer has argued that the Underwriter was acting on its own behalf, not as an agent of the Issuer, when it conducted the tender offer and subsequent remarketing. We believe this point is irrelevant. It appears beyond dispute that the Underwriter's engagement in the Year 2 Transaction was motivated by the potential for profit. The consequence of this conclusion, however, is that a holder of the Year 1 Bonds, the Underwriter, was essentially paying the Issuer for the removal of the redemption uncertainty[4] and the subsequent defeasance of the tendered Year 1 Bonds. This is evidenced most directly by the below market sale of the Refunding Escrow. The effect of a bondholder paying an issuer to alter the terms of debt instrument is a change in the yield of the underlying debt instrument.

In arguing that the $w in funds the Issuer received that was deposited into the Construction and Subsidy Funds did not significantly alter the yield on the Year 1 Bonds, the Issuer prepared a calculation that the change in the yield on all the Year 1 Bonds as a result of such payment would be approximately 10 basis points. This initial computation, however, fails to take into account the below market sale of the Refunding Escrow securities. Taking into account the $r that the Issuer received as "reasonable compensation" for defeasing the $h of the 1988 Bonds purchased by the Underwriter, in addition to the $w specified above, the change in the yield of all the Year 1 Bonds is substantially greater than the 10 basis points determined by the Issuer.

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[4] As stated above, in correspondence the Issuer's representative makes the argument that the benefit received by the Issuer should be viewed as payment to remove the redemption story.

Considering the alterations to the Year 1 Bond documents and the financial benefit the Issuer received in connection with those alterations, there is an argument that under Cottage Savings and prior law all the Year 1 Bonds were materially different as a result of the Year 2 Transaction. The modifications to the Master Indenture, the changes to the redemption provisions, and the change in yield arguably results in an obligation with legally distinct entitlements from those as originally issued. For the reasons discussed below, however, it is our opinion that the Year 2 Transaction resulted in a reissuance of only the Year 1 Refunded Bonds.

Our determination rests primarily on the fact that the financial benefits the Issuer received in connection with the Year 2 Transaction are directly attributable to the Underwriter, a holder of only the Year 1 Refunded Bonds prior to the remarketing. As discussed above, the financial benefit realized by the Issuer through the below market sale of the Refunding Escrow is essentially a payment from a holder of the Year 1 Bonds. The Issuer, through, its representative has also stated that the benefits received by the Issuer were essentially payments from a Bondholder for the removal of the redemption uncertainty and the defeasance of the Year 1 Refunded Bonds through the issuance of the Refunding Bonds. While alterations to the Master Indenture were clearly made in connection with the Year 2 Transaction that impacted all the Year 1 Bonds, the impact upon the Year 1 Bonds that were not defeased and remarketed was incidental to the parties primary objective of modifying the Year 1 Refunded Bonds purchased by the Underwriter. The modifications to the Year 1 Refunded Bonds purchased by the Underwriter enabled it to remarket those bonds at a premium and to pass a portion of the profit along to the Issuer. Accordingly, the financial benefit the Issuer received is more appropriately viewed as consideration for modifying the Year 1 Refunded Bonds held by the Underwriter.

Viewing the financial benefits received by the Issuer as attributable to only the Year 1 Refunded Bonds also impacts the change in yield between the unmodified and modified obligations. By applying the amounts that the Issuer received in connection with the Year 2 Transaction to the Year 1 Refunded Bonds, the change in the yield on those bonds would constitute a significant modification not only under Cottage Savings and prior law, but it would fail to meet the safe harbor for a change in yield discussed under the current regulations.[5]

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[5] Under Treas. Reg. § 1.1001-3(e)(2), a change in the yield of a debt instrument is a significant modification if the yield varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of (A) 1/4 of one percent (25 basis points); or (B) 5 percent of the annual yield of the unmodified instrument (.05 x annual yield). Under these regulations, any change in yield on the Year 1 Bonds would have to exceed approximately 41 basis points to fall

The payments the Issuer received in connection with the Year 2 Transaction also contradicts the Issuer's contention that the alterations to the Year 1 Bonds resulted from the exercise of a unilateral option. Although conceding that Treas. Reg. § 1.1001-3 is inapplicable in this case, the Issuer argues that certain standards set forth in the regulation should be considered here. In particular, the Issuer points to Treas. Reg. § 1.1001-3(c)(2)(iii) which provides that an alteration that results from the exercise of a unilateral option provided to an issuer or a holder to change a term of a debt instrument is not a modification. Under Treas. Reg. § 1.1001-3(c)(3)(iii), an option is unilateral only if, under the terms of an instrument or under applicable law, the exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option) unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information (as defined in Treas. Reg. § 1.446-3(c)(4)(ii)).

To view the alterations made to the Year 1 Bonds as merely pursuant to the exercise of a unilateral option would be to ignore the financial benefits realized by the Issuer. Regardless of whether any alterations to the Year 1 Bonds were preauthorized by the Master Indenture, it is clear that the Issuer received consideration from a holder of the Year 1 Bonds in connection with those alterations. The receipt of a payment in connection with the alterations to the Year 1 Bonds makes it unlikely that the exception for unilateral options under the current regulations would apply.[6]

Accordingly, it is our opinion that as a result of the Year 2 transaction the changes to the Year 1 Refunded Bonds were so material as to amount virtually to the issuance of new securities. The legal entitlements enjoyed by the holders of the Year 1 Refunded Bonds after the Year 2 transaction were sufficiently distinct from the legal entitlements of the holders prior to the transaction to cause a disposition of the Year 1 Refunded Bonds.

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outside of the safe-harbor.

[6] Similarly, the payment received by the Issuer and the resulting impact on the yield of the 1988 Refunded Bonds also refutes the argument that the establishment of sinking fund redemption dates for all the 1988 Bonds pursuant to the early lottery was, at most, only a change in the maturity of the bonds which would not cause a reissuance under prior law.

Relying principally on the Supreme Court's opinion in Cottage Savings, the District's determination is that all the Year 1 Bonds were reissued as a result of the Year 2 transaction. As discussed herein, the evidence compiled by the District supports such a determination. [redacted] we believe that there is a compelling argument that the Year 1 Refunded Bonds were reissued in Year 2. This is based primarily on our opinion that the most egregious aspect of this case is the financial benefit the Issuer received to alter the terms of the Year 1 Refunded Bonds.

[redacted]

[redacted] a court considering all the facts and circumstances is likely to view the Issuer's financial benefit as consideration for altering the terms of the Year 1 Refunded Bonds which were purchased and remarketed by the Underwriter. The documentation obtained by the District and the Issuer's own admissions provide ample evidence of the parties' intent to generate a profit from the excess earnings in the GIC. Circumstantial evidence, including the removal of Trustee 1, the District's assertion that the results of the lottery in Year 2 were provided to the Underwriter before other bondholders, and the sizing of the Refunding Bonds to fully defease the Year 1 Refunded Bonds and provide the Issuer with an additional profit, also casts doubt on the propriety of the Year 2 Transaction. Viewing the payment to the Issuer as consideration from a specific Bondholder, the Underwriter, also results in a change in yield to the Year 1 Refunded Bonds in excess of the safe-harbor amount stated in the current regulations. This alleviates the risk of a court attempting to applying the rationale of the regulations despite their inapplicability to the current case.

The consequence of a reissuance of the Year 1 Bonds, whether all of the bonds or just the Year 1 Refunded Bonds, is that the laws in effect on the date of the reissuance will apply to the bonds. As the District pointed out, the pooled financing rules of I.R.C. § 149 would then apply. Just as importantly, if the Year 1 Refunded Bonds are reissued in Year 2 at a significantly lower yield, the consequence of the payment from the Underwriter to the Issuer, the Year 1 Refunded Bonds are arbitrage bonds under I.R.C. § 148 because the proceeds in the GIC were invested at a materially higher yield.

[redacted]

[redacted]

For the reasons stated herein, it is our opinion that the Service has a strong argument that the Year 1 Refunded Bonds were reissued in Year 2 and any settlement on this issue should substantially favor the Service.

Please call if you have any further questions.

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