Module G

Reissuances

Overview

Introduction

This lesson will discuss the reissuance rules. The reissuance rules govern situations in which there have been changes made to the terms of a bond after issuance. Some terms change so drastically that the bond cannot be considered to be the same issue anymore. Instead, the original issue is considered to be retired, and a new bond takes its place. This lesson explains how to analyze changes in bond terms to determine if there has been a reissuance. It also discusses the consequences of a reissuance.

Background

In *Cottage Savings Association v. Commissioner*, 111 S. Ct. 1503 (1991), the Supreme Court considered the question "When is an exchange of property a taxable exchange of property under IRC section 1001?"

Cottage Savings, a financial institution, simultaneously sold participation interests in mortgages to other financial institutions, and purchased from them participation interests in other mortgages. Cottage Savings argued that the exchange constituted a taxable exchange because the participation interests exchanged were "materially different" because the loans were secured by different properties and different mortgagors.

The IRS argued that no exchange had occurred because the properties were equal in value. The Court considered the issue based on the concept of "material difference" provided by Treas. Reg. section 1.1001-1(a). The Court found that the exchange was a taxable change because the interests were materially different due to the different legal entitlements involved.

This decision created some controversy because it led many to believe that even a slight change in bond terms would give rise to a reissuance. Proposed Regulations under section 1001 were issued in 1992 to provide some guidance regarding when modifications to bond terms would constitute a reissuance. These were greeted with many comments and suggestions by taxpayers. Final regulations were issued in September 1996.

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Objectives

At the end of this lesson, the student will be able to:

- Determine which rules apply to various types of bonds.
- Identify a modification to bond terms.
- Identify a significant modification to bond terms.
- Explain the consequences of a significant modification to bond terms.
- Identify a qualified tender bond.
- Determine the changes to a qualified tender bond that will result in a reissuance.

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Introduction to Reissuances

How Reissuances Work

Suppose that City M, with a $20M 9 percent bond issue outstanding, runs into financial problems, and is unable to make any debt service payments in the foreseeable future. What options does the city have? It has a few.

It can:

- default on the bonds, which would ruin its credit rating, and prevent it from obtaining future funds at any semblance of a reasonable interest rate.
- borrow from a bank — at the current rate of interest.
- sell some assets or investments.
- re-negotiate the terms of the bonds with the bondholders.

Let's assume that the bondholders agree to lower the interest rate from 9 percent to 6 percent, and to extend the maturity date by five years. The city has its bond rating intact, and the bondholders still have a viable investment. However, have these changes altered the bond terms so much so that the original issue is no longer recognizable? Is this actually a new bond issue? The answer to both questions is yes.

Consequences of a Reissuance

Let's assume that you have been assigned to examine this bond issue after the changes have been made. You analyze the changes, compare them with the reissuance rules, and decide that you are looking at two distinct issues. What does this mean for the city? Your determination would have the following effects:

- On the effective date of the agreement, new bonds have been issued.
- The original bonds are considered to be retired.
- The new issue is a "current refunding" of the original bond.
- The new issue is now subject to the current tax laws.
- The bondholders would be required to report a taxable exchange.

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Why Should Issuers Care About These Effects?

Let's assume again that the original bonds were issued in 1983. Let's also assume that the city was clever enough to invest its reserve fund in long-term investments yielding 9.0125 percent. City M will care about the effects of this reissuance for the following reasons:

First, the new bonds are now subject to the current tax laws, including rebate. This means that any earnings on the investments over the yield on the reissued bonds must be rebated to the U.S. government. Obviously, the yield on the reissued bonds is less than that on the original bonds. And since these changes were made a few years prior to your visit, the city may have invested some funds at the higher yield.

Second, the bondholders will have to amend their tax returns to reflect the taxable exchange. After explaining this, you now have the issuer's attention.

Where Are the Reissuance Rules?

By now, your interest piqued, you have frantically searched sections 141 through 150 of the Code for the reissuance rules, only to be disappointed. You can't find them anywhere. That's because the reissuance rules stem from section 1001. Treas. Reg. section 1001 governs the computation and recognition of gain or loss in the sale or disposition of property. Tax exempt bonds are property. Treas. Reg. section 1.1001-1 expands on the term "disposition" by including an "exchange of property for other property differing materially either in kind or in extent." It is this provision that brings changes (or modifications) of the terms of bonds under the jurisdiction of IRC section 1001.

The question is — how material must the modification be in order for it to constitute a new bond? Treas. Reg. section 1.1001-3 provides the most recent guidance. These regulations apply to alterations of the terms of debt instruments on or after September 24, 1996. Taxpayers may also rely on this section for alterations of the terms of a debt instrument after December 2, 1992 and before September 24, 1996. This section provides rules for determining when a modification of the terms of a debt instrument results in an exchange for Treas. Reg. section 1.1001-1(a) purposes.

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Introduction to Reissuances, Continued

Where Are the Reissuance Rules? (continued)

Obviously, there are occasions when issuers need to make minor changes to the terms of the issue, and these are certainly permitted. However, the rules are designed to prevent those changes which materially change the issue.

These rules pertain to both taxable and tax exempt securities.

Qualified Tender Bonds

Notice 88-130 provides additional rules for qualified tender bonds and is discussed in Part 2 of this lesson.

Part 1: Treas. Reg. Section 1.1001-3

Overview

Introduction

Treas. Reg. section 1.1001-3 attempts to clear up some of the confusion about when changes to bond terms will result in the deemed exchange of the old bond for a new bond (a reissuance.) However, these regulations contain many rules, with exceptions to the rules, and exceptions to the exceptions to the rules.

Treas. Reg. Section 1.1001-3(b) provides the general rule for exchanges. It states that only a significant modification will result in an exchange.

Paragraphs (c) and (d) define "modification" and provide examples.

Paragraphs (e) and (f) provide rules for determining when a modification is a significant modification.

Only a significant modification can result in a reissuance.

This Section Applies to…

This section applies to any modification of a debt instrument, regardless of the form of the modification. Examples of some forms are:

- an exchange of a new instrument for an existing debt instrument
- an amendment of an existing debt instrument
- modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties.

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This Section Does NOT Apply to…

This section does not apply to:

- tax exempt bonds that are qualified tender bonds. Notice 88-130 governs these bonds and will be discussed later in this lesson.
- exchanges of debt instruments between holders.

For example, if Bondholder A exchanges his City A bonds with Bondholder B who holds City B bonds, the transaction would constitute an exchange of property and would be a taxable event. None of the terms of the bonds themselves have changed, therefore this section doesn't apply.

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Section 1:

Modifications to Debt Instruments

General Rules

Definition of a "Modification"

Treas. Reg. section 1.1001-3(c)(1)(i) states that in general, a modification is any alteration of a legal right or obligation of the issuer or holder of a debt instrument.

However, the following alterations are **not** modifications:

- with some exceptions, alterations that occur by operation of the terms of the debt instrument (Treas. Reg. section 1.1001-3(c)(1)(ii)),
- failure of an issuer to perform its obligations (Treas. Reg. section 1.1001-3(c)(4))
- failure of either party to a debt instrument to exercise an option (Treas. Reg. section 1.1001-3(c)(5))

The following examples will help to explain these.

Example

A financial institution holds bonds issued by a municipality. The indenture provides for an increase in the interest rate paid on the bonds, if the marginal federal corporate income tax rate increases. When the corporate rate does increase, the financial institution waives its right to an increased interest rate.

This waiver constitutes an alteration in the holder's legal rights, and is a modification. The provision allowing for an adjustment in the interest rate does not constitute a modification because it occurs by operation of the bond terms. It is the holder's waiver of its right that constituted a modification. **(See Rev. Rul. 87-19, 1987-1 CB 712.)**

Continued on next page

Definition of a "Modification", continued

Example

City C is unable to make a scheduled payment of principal and interest on its outstanding bonds, thus defaulting on the bonds. Under the terms of the bonds, when the issuer fails to make a scheduled payment, the full principal amount of the bond is due immediately. The bondholders waive this right and instead negotiate new terms with the city.

According to Treas. Reg. section 1.1001-3(c)(4)(i), the issuer's failure to make the scheduled payment is not a modification. In addition, according to Treas. Reg. section 1.1001-3(c)(4)(ii), the bondholder's waiver of collection rights is not considered a modification, until the bondholders have waited for payment longer than two years. This time period can be extended as long as the parties are conducting good faith negotiations or the issuer is in receivership, foreclosure, or a similar proceedings as described in IRC section 368(3)(A). However, as soon as the parties reach agreement regarding new terms, these new terms constitute a modification.

Alterations Which Occur by Operation of the Terms of the Instrument that ARE Modifications

Treas. Reg. section 1.1001-3(c)(2) contains three exceptions to the general rule that states that alterations that occur by operation of the terms of the instrument are not modifications. Therefore, the following three alterations **are** modifications, **even though they are provided for in the indenture**:

- change in obligor or nature of instrument,
- a change that results in an instrument that is not debt for federal income tax purposes (debt to equity), and
- certain alterations resulting from the exercise of an option

Exercise of Options

Treas. Reg. section 1.1001-3(c)(2)(iii) states that an alteration resulting from the exercise of an option provided to an issuer or holder to change a term of a debt instrument is a modification, unless:

- the option is unilateral (defined below) **and**,
- the exercise of the option does not result in the deferral of, or a reduction in, any scheduled debt service payment. (This requirement pertains only to the holder of the instrument.)

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Definition of Unilateral Option

Under Treas. Reg. section 1.1001-3(c)(3), an option is unilateral if, under the terms of the indenture or applicable law:

- the other party does **not** have the right to alter or terminate the instrument, or put the instrument to a person related to the issuer

- exercise of the option does not require consent or approval of:

  - the other party,
  - a person related to the other party, or
  - a court or arbitrator, **and**

- exercise of the option does not require consideration (other than incidental costs) unless on the issue date of the instrument, the consideration is:

  - a de minimis amount,
  - a specified amount, or
  - an amount based on a formula using objective financial information.

Options Flowchart

After you have determined whether or not the option is unilateral, use the flowchart in Figure G-1 to determine whether or not the alteration resulting from the exercise of the option is a modification.

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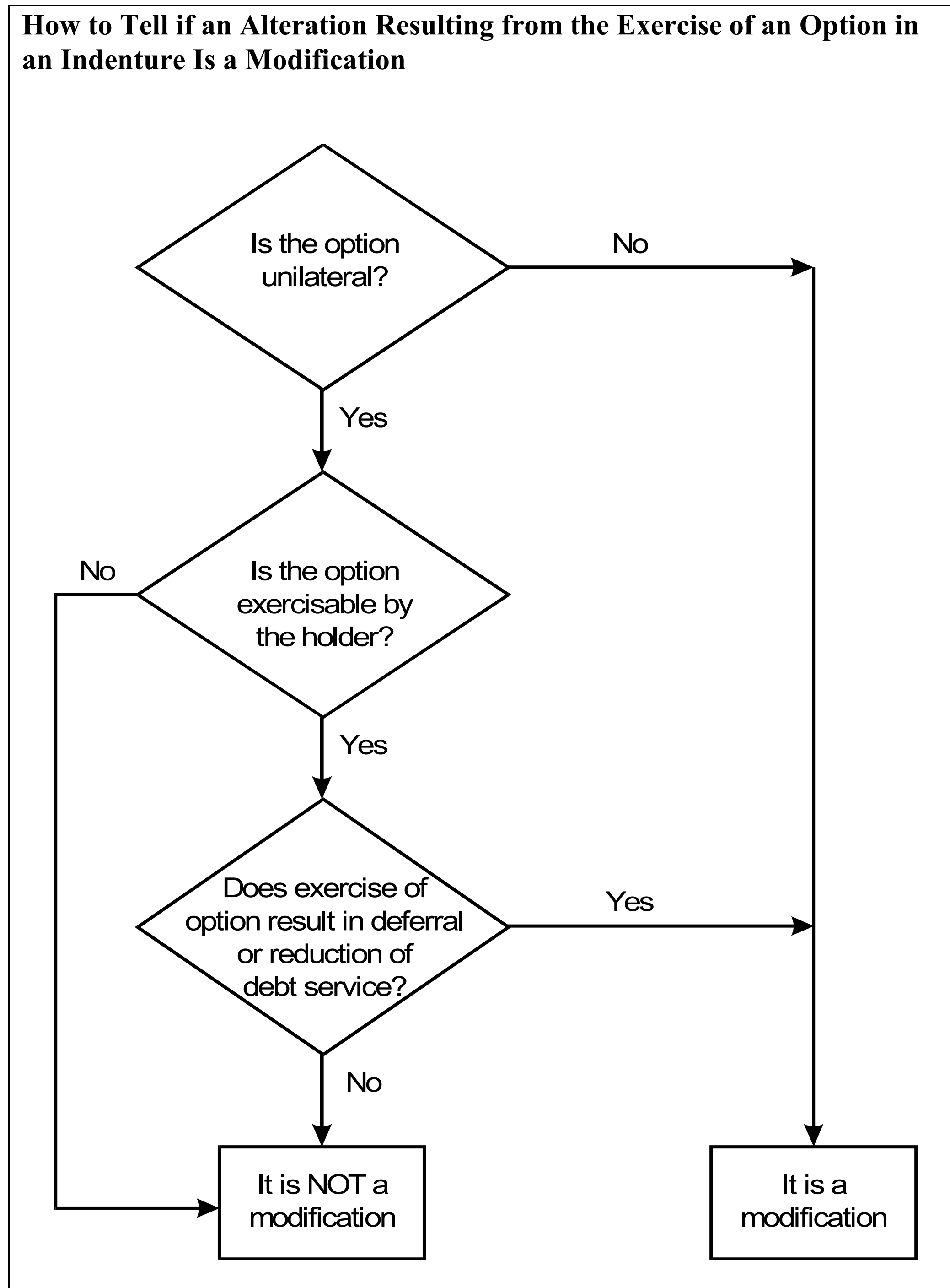
Figure G-1

How to Tell if an Alteration Resulting from the Exercise of an Option in an Indenture Is a Modification



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Example

The original terms of the bond indenture provide for a variable interest rate, reset annually based on the value of an objective index. Under the terms of the indenture, the issuer may, upon the payment of a fee equal to a specified percentage of the outstanding principal amount of the bond, convert to a fixed rate of interest as determined based on the value of a second objective index. The exercise of the option does not require the consent or approval of any person or create a right of the holder to alter the terms of, or to put, the instrument.

Because the required consideration to exercise the option is a specified amount fixed on the issue date, the exercise of the option is unilateral. The conversion to a fixed rate of interest is not an alteration. Therefore, the change in the type of interest rate occurs by operation of the terms of the indenture and is not a modification.

Example

City K issues eight year bonds, which are purchased by a bank. Under the terms of the bonds, the bank has the option to increase the interest rate by a specified amount if the city's credit rating declines by a certain amount. The bank's right to increase the interest rate is a unilateral option.

The city's credit rating declines below the specified level, and the bank exercises its option to increase the interest rate. The increase occurs by operation of the terms of the bond and does not result in a deferral or a reduction in the scheduled payments. Therefore, the change is not a modification.

Example

City L issues 10-year bonds, which are purchased by a bank. Interest is payable semi-annually. Under the terms of the bond, the bank may grant the city the right to defer all or part of the interest payments. For any payments that are deferred, interest will compound at a rate 1.5 percent greater than the stated rate of interest.

The city encounters financial difficulty and is unable to meet scheduled interest payments. The bank exercises its option and grants the city the right to defer payments. The exercise of the option results in a right of the city to defer scheduled payments, and is not a unilateral option. Thus the alteration is a modification.

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The General Rule Revisited

Remember that the general rule of Treas. Reg. section 1.1001-3(b) states that a modification that is not a **significant** modification is not an exchange for purposes of Treas. Reg. Section 1.1001-1(a).

We have discussed various types of modifications above. However, now we need to find out what is needed to make a modification "significant." In order to have a reissuance, we must have a significant modification to the bond terms.

Section 2:

Significant Modifications

Overview

General Rule

Treas. Reg. section 1.1001-3(e)(1) provides that:

> "***except as otherwise provided in paragraphs (e)(2) through (6) of this section, 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."

It goes on to state that when there have been a lot of insignificant modifications, **other than those described in paragraphs (e)(2) through (6)**, they should all be considered together to determine if collectively they comprise a significant modification.

This is an important rule to remember. As we will see, if a change in terms is not described in paragraphs (e)(2) through (6), then we will use the general rule to test for significance.

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Specific Changes Included in the Regulations

Treas. Reg. section 1.1001-3(e) discusses certain changes in terms of an instrument, and determines whether or not they are significant modifications.

A change in terms may not **be** a significant modification, but it may **result** in a significant modification. For example, an extension of a maturity date is not considered to be a significant modification, however this extension will affect the bond yield. This change in yield may result in a significant modification. Therefore, when you uncover a change in terms, you must check all of the changes provided in the regulations, to determine if there is a significant modification. The specific types of changes which are covered in the regulations are:

- change in yield,
- change in timing of payments
- change in obligor
- change in security or credit enhancement
- change in priority of debt
- change in nature of a debt instrument, and
- change in accounting or financial covenants.

All but the last two of these changes are discussed in detail below.

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Change in Yield

Applicability

Treas. Reg. section 1.1001-3(e)(2) applies to debt instruments with the following types of payment schedules:

- fixed payments,
- alternative payment schedules subject to Treas. Reg. section 1.1272-1(c),
- fixed yield instruments subject to Treas. Reg. section 1.1272-1(d), and
- variable rate instruments.

Treas. Reg. section 1.1272 covers yield computation of certain debt instruments subject to original issue discount.

(Remember that since this section applies to both taxable and tax-exempt bonds, there will be some rules which will not be important to us, because we will rarely see them.)

General Rule

A change in yield will be a significant modification if there is a difference between:

- The yield of the modified bond and
- The yield of the original bond

Of more than the greater of:

- 1/4 of one percent (0.25 percent), **or**
- five percent of the annual yield of the original bond.

Adjusted Issue Price

When computing the yield of the modified bond, Treas. Reg. section 1.001(e)(2)(iii)(A) requires that certain adjustments be made to the adjusted issue price. The following adjustments to issue price should be made on the date of modification:

Increases	Decreases
accrued but unpaid interest	accrued but unpaid bond insurance premium
payments made to issuer as consideration for modification	payments made to holder as consideration for modification

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Adjusted Issue Price, continued

Example

Assume that City C sells its $10M five percent bonds for $10,100,000. A few years later, some of the principal payments are deferred, and the issuer pays the bondholders $50,000 to defer the payments. Assume that the deferral results in a change of yield greater than 0.25 percent. When the yield is computed on the modified issue, the issue price would be adjusted downward by $50,000 to $10,050,000. This is the issue price that will be used in the yield computation.

A Word to the Wise

You will find that different types of changes in bond terms will affect the yield. For example, unexpected payments to issuers or bondholders will affect the yield, because they increase or decrease (respectively) the amount of proceeds available.

Similarly, accelerated or deferred payments affect the yield because they change the timing of the bondholders' payments.

Therefore, regardless of the type of change that has been made to the bond terms, you should always check to see what effect it has had on the yield.

Change in Timing of Payments

General Rule

Treas. Reg. section 1.1001-3(e)(3)(i) provides that a change in the timing of payments is a significant modification if it results in a material deferral of scheduled payments. The deferral can be an extension of the final maturity date or a deferral of payments due prior to maturity. The materiality depends on all of the facts and circumstances, including the following factors:

- length of deferral,
- original term of the bond,
- amounts of the payments that are deferred, and
- the time period between the modification and the actual deferral of payments.

Safe Harbor Period

Treas. Reg. section 1.1001-3(e)(3)(ii) provides for a safe harbor period. The deferral of one or more scheduled payments within the safe harbor period is **not** a material deferral (and not a significant modification) if the deferred payments are unconditionally payable by the end of the safe harbor period.

The safe harbor period:

Begins on…	And extends for a period equal to the lesser of…
the original due date of the first scheduled payment that is deferred	• five years, or • 50 percent of the original term of the bond.

Example

County M issues $1M of 20-year bonds at 10 percent. Interest is payable at the end of each year. At the beginning of Year 11, the parties agree to defer all remaining interest payments until maturity with compounding. The yield of the modified bond remains at 10 percent.

The safe harbor period begins at the **end** of Year 11 (when the interest payment for that year is deferred). The period ends at the end of the sixteenth year (the lesser of five or 10 years). The payments are not unconditionally payable by the end of this five-year period, because they are not payable until maturity. Therefore, the deferral of the interest payments is not within the safe harbor period and this modification materially defers the payments due. It is a significant modification.

Change in Obligor

Introduction

Whether or not a change in obligor on a bond is a significant modification depends on whether or not the debt is recourse or nonrecourse.

Who Is an Obligor?

According to Treas. Reg. section 1.1001-3(f)(5), the term "obligor" means the issuer of the bonds. Further, Treas. Reg. section 1.1001-3(f)(6)(i) states that the obligor of a tax-exempt bond is the entity that actually issues the bonds and **not** a conduit borrower of the proceeds. Further, Treas. Reg. section 1.1001-3(f)(5)(iv) states that the terms "conduit loan" and "conduit borrower" have the same meanings as in Treas. Reg. section 1.150-1(b). This part of Treas. Reg. section 1.150 discusses refundings.

Reference to Section 1.150-1

As experienced revenue agents, you know by now that whenever one code section refers to another code section, life is going to get complicated. This is one of those times. The specific section to which Treas. Reg. section 1.1001 has referred us is innocent enough, but if we continue reading until Treas. Reg. sections 1.150-1(d)(2)(ii)(A) and (B), we find a definition of "obligor" and a provision about issues with different obligors. This means that we are going to have to reconcile these two definitions. But a reconciliation of these two sections was inevitable anyway because of the relationship between reissuances and refundings. However, we'll wait for a bit to do that.

Continued on next page

Recourse vs Non-Recourse Debt

Generally speaking, a recourse debt instrument is one in which the lender or bondholder has the right to look to the borrower's assets for payment, if the borrower defaults. The lender is not limited to the collateral used to secure the loan, such as in nonrecourse debt. Section 1.1001-3(f)(6) defines recourse and nonrecourse debt as follows:

Recourse	Nonrecourse Debt
tax exempt bond that does not finance a conduit loan.	Tax exempt bond secured by a trust (or escrow) holding government securities or tax exempt government bonds that are expected to pay debt service.
tax exempt bond that finances a conduit loan, unless both the bond and the conduit loan are non-recourse debt.	tax exempt bond that finances a project and only project revenues are pledged to pay the debt.

General Rule for Recourse Debt

Treas. Reg. section 1.1001-3(e)(4)(i)(A) provides that the substitution of a new obligor on a recourse debt instrument is a significant modification, except for those transactions indicated below.

Exception for Certain Asset Acquisitions

The substitution of a new obligor is not a significant modification:

- if the new obligor acquires substantially all of the assets of the original obligor,
- the transaction does not result in a change in payment expectations, and
- the transaction does not result in a significant alteration.

Exception for Tax Exempt Bonds

Treas. Reg. section 1.1001-3(e)(4)(i)(D) provides that the substitution of a new obligor on a tax-exempt bond is not a significant modification if:

- the new obligor is a related entity to the original obligor as defined in IRC section 168(h)(4)(A), and
- the collateral securing the obligation includes the original collateral.

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Related Entities

IRC section 168(h)(4)(A) states that each governmental unit, and each agency or instrumentality of a governmental unit is related to each other as long as they all derive their powers, rights, and duties from the same sovereign authority.

Nonrecourse Debt

The substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

Co-ordination of Treas. Reg. Sections 1.1001-3 and 1.150-1

Short Review

We learned earlier in this section that a change in obligor on tax exempt bonds would not be a deemed reissuance if the obligors were related and the collateral includes the original collateral. We also learned that under Treas. Reg. section 1.1001-3, "obligor" means the issuer of the bonds, and not the conduit borrower. We also learned that whenever we have a deemed reissuance of a tax exempt bond, it will usually be considered to be a current refunding. Let's turn to Treas. Reg. section 1.150-1(d)(2)(ii)(A), which discusses refunding issues with different obligors.

Obligor Under Treas. Reg. Section 1.150-1

Treas. Reg. section 1.150-1(d)(2)(ii)(A) states that to be a refunding issue, the obligors must be the same or related. "Obligor" is defined in section 1.150-1(d)(2)(ii)(B) as the actual issuer of the issue, unless there is a conduit borrower, in which case the conduit borrower is the obligor of the issue. Now let's reconcile these definitions as they apply to tax-exempt recourse debt:

Relationship of the Obligors	Section 1.1001	Section 1.150
Related issuer	not a reissuance	refunding
Unrelated issuer	reissuance	not a refunding
Related conduit borrowers	N/A	refunding
Unrelated conduit borrowers	N/A	not a refunding

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Data for Examples

Let's look at some examples to see how these definitions relate to each other. Here is our cast of characters:

Issuer A	Conduit Borrower A
Issuer B	Conduit Borrower B
Issuer C	Conduit Borrower C

Issuers A and B are related to each other but to no one else.

Conduit Borrowers A and B are related to each other but to no one else. All of the issuers are governmental units, and all of the borrowers are exempt under IRC section 501(c)(3).

All of the debt is recourse debt.

Example 1: Related Issuers

Issuer A issues bonds to update the electrical system. Electrical service revenues and general credit are pledged to pay debt service. Later, Issuer A dissolves into Issuer B and Issuer B substitutes its name on the bonds as the obligor.

Q: What are the effects of this change under Treas. Reg. sections 1.1001-3 and 1.150-1?

A: Under Treas. Reg. Section 1.1001-3, the obligor is always the issuer. Since the issuers are related, the change does not constitute a reissuance.

Because there is no reissuance, there is no reason to look at the issue under Treas. Reg. section 1.150-1.

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Example 2: Unrelated Conduit Borrowers

Issuer A issues bonds and lends the proceeds to Borrower A. The bonds are secured by a note from Borrower A to Issuer A. Later, Borrower A sells the property built with the proceeds to Borrower C, who signs a new note to Issuer A for the outstanding amount.

Q: What are the effects of this transaction?

A: Under Treas. Reg. section 1.1001-3, the obligor is always the issuer, and the issuer has not changed. There can't be a reissuance due to a change in obligor with Treas. Reg. section 1.1001 because the conduit borrower is never considered to be an obligor. However, there has been a reissuance of the note under Treas. Reg. section 1.1001-3, because of the change of obligor on the note. Because the note is the security for the bond, we must determine if there has been a reissuance due to a change in security. Treas. Reg. section 1.1001-3(e)(4)(iv) tells us that a change in security is a significant modification if the modification results in a change in payment expectations. The obligor's capacity includes the borrowers' ability to pay. If both borrowers have equal credit ratings, then there would be no change in payment expectations, and there would not be a reissuance. If there was a change in payment expectations, then there would be a reissuance.

If there is a reissuance under Treas. Reg. section 1.1001-3, then we would have to classify the reissued bond under Treas. Reg. section 1.150-1. Under Treas. Reg. section 1.150-1, the obligors are the conduit borrowers and they are unrelated. Treas. Reg. section 1.150-1 requires that the obligors be related in order to constitute a refunding. Because they are not, this transaction would be classified as a new issue used to acquire assets.

If the conduit borrowers were related, then the transaction would be classified as a current refunding.

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Example 3: Unrelated Issuers

Issuer A issues bonds to repair and maintain a sewer system. Sewer revenues and general credit are pledged to pay debt service. Later, Issuer A turns over operation of the system to Issuer C, and Issuer C substitutes itself as obligor on the bonds. Sewer revenues will still pay debt service.

Q: What are the effects of this transaction?

A: Under Treas. Reg. section 1.1001-3, since the obligors are unrelated, the transaction results in a significant modification, and a reissuance.

Under Treas. Reg. section 1.150-1, since the obligors are unrelated, there cannot be a refunding. Therefore, it would be classified as an asset acquisition.

Example 4 Original Bonds are Retired

Issuer A issues bonds to build a new airport terminal. Airport revenues are expected to pay debt service. Later, Issuer A sells the terminal and its operations to Issuer C. Issuer A uses the sale proceeds to redeem the bonds. Issuer C immediately issues new bonds to finance the purchase, using the airport revenues as security.

Q: What are the effects of this transaction?

A: Treas. Reg. section 1.1001-3 does not apply to these bonds, because the original bonds have been retired and new bonds have been issued.

Under Treas. Reg. section 1.150-1, this would be considered to be an asset acquisition.

Q: How would this change if Issuer B purchased the airport?

Again, Treas. Reg. section 1.1001-3 does not apply, because the original bonds have been retired, and new bonds have been issued.

Under Treas. Reg. section 1.150-1, Issuer B’s issue would be considered to be a refunding of the first issue, because the issuers are related.

Change in Security or Credit Enhancement

Recourse Debt

Treas. Reg. Section 1.1001-3(e)(4)(iv)(A) states that a modification that releases, substitutes, adds, or otherwise alters the:

- collateral for,
- a guarantee on,
- or other form of credit enhancement

for a recourse debt instrument is a significant modification, **if** the modification results in a change in payment expectations.

Change in Payment Expectations

A change in payment expectations occurs if, as a result of the transaction the obligor's capacity substantially improves or declines. The obligor's capacity includes any source of payment, including collateral, guarantees, or other credit enhancements.

Nonrecourse Debt

Treas. Reg. Section 1.1001-3(e)(4)(iv)(B) states that, with certain exceptions a modification that releases, substitutes, adds, or otherwise alters a substantial amount of the:

- collateral for,
- a guarantee on,
- or other form of credit enhancement

for a nonrecourse debt instrument is a significant modification.

Exceptions

The following modifications of security of nonrecourse debt are **not** significant modifications:

- substitution of collateral where the specific units pledged are easily exchangeable (for example, government securities or financial instruments of a particularly type and rating.)
- substitution of a similar commercially available credit enhancement contract,
- improvement to the property securing the obligation.

Change in Priority of Debt

Rule for both Recourse and Nonrecourse Debt

Treas. Reg. Section 1.1001-3(e)(4)(v) states that a change in the priority of an obligation relative to the issuer's other debt is a significant modification if it results in a change in payment expectations.

Defeasance of Tax Exempt Bonds

General Rule

Treas. Reg. section 1.1001-3(e)(5)(ii)(B)(1) provides that a defeasance of a tax exempt bond is not a significant modification, even if the issuer is released from any liability to make payments, if:

- the defeasance occurs by operation of the terms of the original bond, and
- the issuer places in escrow government securities or tax-exempt government bonds that are expected to pay the debt service.

What Is a Defeasance?

You will recall from earlier modules that the term “defeasance” relates to advance refundings. On the date that the refunding bonds are issued, the refunded (original) bonds have a new status. They are no longer considered to be outstanding, nor are they redeemed (retired). They are “defeased.” This means that the source of income that was pledged to pay debt service on the refunded issue is no longer reserved for it. (It will probably be used to pay the debt service on the refunding issue.) Now, however, the debt service on the refunded issue will be paid by the income generated from the proceeds invested in government securities.

Purpose of the Defeasance Provision

This provision was added to the 1.1001-3 regulations in order to preserve advance refundings, and to prevent tax ramifications for bondholders in advance refundings. Advance refundings are by their nature reissuances. But, the tax ramifications for bondholders of the refunded issue would be burdensome. In addition, if an advance refunding constituted a reissuance, it would have to be a current refunding, and we would have a current refunding of an advance refunding! Therefore, this provision eliminates all of these problems.

How to Use the Rules to Test for Significance

General Rule

Treas. Reg. section 1.1001-3(f)(1) provides that a modification should be tested first under each specific rule listed in paragraphs 1.1001-3(e)(2) through (6).

If the modification is not specifically addressed in one of these paragraphs, then the general rule of section 1.1001-3(e)(1) should be used.

Example
Under the terms of a 30-year fixed-rate bond, the issuer can call the bond for 102 percent of par at the end of ten years. At the end of the eighth year, the holder of the bond pays the issuer to waive the issuer's right to call the bond at the end of the tenth year. On the date of the modification, the issuer's credit rating is approximately the same as when the bond was issued, but market rates of interest have declined from that date.

The holder's payment changes the yield on the bond. That change must be evaluated to determine if it is enough to result in a significant modification, If the change in yield is not a significant modification, the elimination of the issuer's call right must also be tested for significance. Because the rules of section 1.100 1-3(e) do not specifically address this change, its significance must be evaluated under the general rule of section 1.1001-3(e)(1).

Contingent Modifications

If the modification is specifically addressed in the regulations, but is only effective upon the occurrence of a substantial contingency, then the determination of whether or not the modification is significant should be made using the general rule.

Modifications That Do Not Meet the Significance Tests

If a modification does not meet the test(s) required to be a significant modification set forth in the regulations, then it is **not** a significant modification under that rule.

Example
If a change in terms results in a change in yield of less than the greater of 0.25 percent, or five percent of the annual yield of the unmodified instrument, there is not a significant modification under this rule. However, that does not eliminate the possibility that there could be a significant modification under another rule, or even the general rule.

Continued on next page

Cumulative Effects of Modification

Treas. Reg. section 1.1001-3(f)(3) states that two or more modifications over any period of time constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification under any of the rules of section 1.1001-3(e).

When testing for changes of yield, though, any prior modification which occurred more than five years before the modification being tested is disregarded.

Modifications of Different Terms

Treas. Reg. section 1.1001-3(f)(4) states that modifications of different terms, none of which are separately significant, under paragraphs (e)(2) through (e)(6), are not collectively significant.

Contrast this rule with the general rule of paragraph (e)(1), which provides that a lot of insignificant modifications, other than those described in paragraphs (e)(2) through (e)(6), may be collectively significant.

Part 2

Notice 88-130

Overview

Introduction

In Part 1, we learned that the reissuance rules of Treas. Reg. section 1.1001-3 cover all bonds. We also learned that qualified tender bonds are also required to meet the additional rules of Notice 88-130. Part 2 will discuss these additional rules for qualified tender bonds. Qualified tender bonds deserve their own set of rules, basically because they are different from other bonds, and cannot easily be analyzed under Treas. Reg. section 1.1001-3. These rules are summarized in Notice 88-130, which is generally effective for bonds originally sold after December 14, 1988. The rules apply to any bond that is subject to a tender right regardless of when sold, with some exceptions for bonds sold on or before December 14, 1988.

Generally, tender bonds are variable rate bonds or "variable rate demand bonds." In Part 1, we discussed bonds that had a fixed rate of interest. The interest rate (or coupon) was determined on the issuance date and stayed the same until maturity. Note however, that all of the bonds in a series may not have the same interest rate. A bond issue will usually comprise serial bonds and term bonds, and all may have different interest rates.

Let's look at an example:

Continued on next page

Example

County W issues $1,345,000 5-year bonds on December 1, 1989. The issue is composed of serial and term bonds, as shown in the maturity schedule below:

Maturity Schedule		
Serial Bonds:		
Year Maturing	**Amount Maturing**	**Interest Rate**
1990	$80,000	5.90 percent
1991	$85,000	6.00 percent
1992	$85,000	6.10 percent
1993	$95,000	6.15 percent
1994	$100,000	6.20 percent
Term Bonds:		
Year Maturing	**Amount Maturing**	**Interest Rate**
1994	$900,000	6.9

Fixed Rate Bonds

As you can see, each of the bonds in the series has a different interest rate. This is because of the term structure of interest rates. Instruments with short terms have lower rates than long-term instruments. Even though there are varied interest rates within the series, this issue is still considered to be a fixed rate issue. The rate could be referred to as "fixed, but varied," but it would not be referred to as a variable rate bond.

In This Part

This part contains the following topics:

Topic	See Page
Overview	G-31
Variable Rate Demand Obligations	G-33
Qualified Tender Bonds	G-34

Variable Rate Demand Obligations

General

Variable rate bonds, or "variable rate demand obligations" differ from fixed rate bonds in two important ways:

- the interest rate on variable rate bonds changes periodically on a certain date determined in the indenture, **and**
- bondholders can demand that their bonds be purchased by the tender agent at specified intervals.

These features are discussed in more detail below.

Interest Rate Changes

The rate usually changes on a daily, weekly, or monthly basis, but can also change quarterly, semi-annually, or annually. The rate is usually based on an index plus a spread.

For example, let's assume that the indenture provides that the interest rate will be reset each month based on the Banker's Trust's Index of Short Term Obligations, plus a spread of 0.5 percent. At the end of each month, the rate will be re-established according to the index, and will apply for the coming month.

Demand Feature

Generally, each time the interest rate changes, the holder can tender the bonds for purchase at par plus accrued interest, prior to the final maturity date. This is called a **tender right**. Sometimes the demand feature may be allowed more often than the interest rate change. The bond indenture will specify when the bondholders can tender their bonds. This means that bondholders who want to sell their bonds contact the tender agent, notifying the agent that the bonds will be tendered for sale. The tender agent contacts a dealer, who attempts to sell the bonds to another investor. Because bondholders have this right to tender their bonds, the issuer usually has some means available to provide cash to purchase the bonds, if other investors aren't available. Some common methods of providing cash are letters of credit or standby purchase agreements.

As you can guess, although these bonds are considered to be long-term obligations, they carry short-term yields.

Qualified Tender Bonds

What Is a Qualified Tender Bond?

A qualified tender bond is any tender bond which has a final stated maturity date no later than the earlier of:

a. the date which is 35 years after the date of issue, **or**

b. the latest date reasonably expected (as of the date of issue) to carry out the governmental purpose of the issue of which the bond is a part.

A bond will be deemed to meet (b) above if:

- the average maturity of the issue of which the bond is a part does not exceed 120 percent of the average reasonably expected economic life of the facilities being financed with the proceeds of such issue (as determined under IRC section 147(b).)

When Are Qualified Tender Bonds Considered To Be Retired?

According to Notice 88-130, a qualified tender bond will be considered to be retired (reissued) only if:

- There is any change to the terms of the bond (other than a qualified corrective change) in connection with a qualified tender change which changes the time between tender dates in one of the following ways:
  - the period between tender dates changes from one not exceeding one year to a period exceeding one year, or
  - the period between tender dates changes from one exceeding one year to a period not exceeding one year.
- There is a nonqualified tender change of the period between tender dates.
- There is a change to the bond terms (other than a qualified corrective change) which would cause a disposition of the bond under section 1001 without regard to the existence or exercise of the tender right.
- The bond is purchased or acquired by or on behalf of the issuer or a true obligor which is a governmental unit or an agency or instrumentality thereof, or
- The bond is otherwise retired or redeemed.

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When Are Qualified Tender Bonds Considered To Be Retired?, (continued)

Example

City A issues qualified tender bonds on June 1, 1995. When issued, the bond documents provided that the security for the bonds would be solely from taxes received from the operation of the project. The bond documents also provided that the interest rate on the bonds would be reset each January 1, at the lowest rate that would enable the bonds to trade at par on that date. The bond documents also provide that the period between tender dates could be increased or decreased at the City's discretion. In May 1997, the City changed the security for the bonds to the project revenues. Additionally, the City changed the period between tender dates to 13 months.

Because there is a change in bond terms (change in security) in connection with a qualified tender change (change between tender dates), the bonds will be treated as retired.

Example

City C issues qualified tender bonds on January 1, 1996. The bond documents provide for a variable rate of interest based on the Banker's Trust Index plus a spread of .05 percent. Interest is to be paid each June 1. On January 1, 1997, the City proposes to increase the spread to 0.5 percent. This increase will increase the yield on the bonds by an amount greater than 0.25 percent.

The change in bond yield is more than the permitted maximum under Treas. Reg. section 1.1001-3(e)(2)(ii). This change would trigger a disposition under this regulation. Therefore, these bonds would be considered to be retired.

This rule is designed to ensure that qualified tender bonds do not receive more favorable treatment than that accorded bonds not subject to a tender right.

When Are Qualified Tender Bonds NOT Treated as Retired?

A qualified tender bond will not be treated as retired merely by reason of the existence of the tender right, a qualified tender purchase, a qualified tender change, a qualified corrective change, **or** any combination of the above.

Continued on next page

Definitions

See Notice 88-130, Exhibit G-1, for the definitions regarding qualified tender bonds.

Class Exercises and Problems

Exercise 1

According to the bond indenture, the interest rate on County F's bonds is adjusted each January 1st to reflect current market conditions. This rate is based on a fixed percentage of the Chase Manhattan Prime Rate. On January 1, 1997, the interest rate decreases from 3.8 percent to 3.5 percent.

Is this a significant modification? Cite your source.

Exercise 2

County K's housing agency issues bonds on December 1, 1996, which are sold to the public at par. The bonds are subject to a tender right. The agency proposes to modify the bonds to extend the due date of the next principal payment for two years. The agency is concerned that this change will constitute a reissuance.

Which document contains the reissuance rules for these bonds?

Exercise 3

According to the bond indenture, the interest on County H's bonds are based on a floating rate. The floating rate is equal to a percentage of a bank's base rate, plus a fixed interest component of 0.5 percent. The county proposes to reduce the fixed interest component to 0.3 percent. Presently, the annual yield on the bonds is 3 percent. This is the only change contemplated by the county.

Would this adjustment result in a significant modification? Cite your source.

Continued on next page

Exercise 4

County M issues $4,000,000 of 30-year bonds @ 4 percent on November 1, 1996. Interest is payable every February 1 and August 1. Principal payments are due every August 1. On June 1, 1999, County M notifies the bondholders of its financial problems. The parties agree to defer the principal payments due on August 1, 1999 through 2003, although interest payments will be made as scheduled. The principal payments will be made in a lump sum on August 1, 2004, along with the regularly scheduled payment also due that day.

Is this a significant modification? Cite your source.

Exercise 5

County Q's hospital authority issues bonds to build a hospital. The hospital and its revenues are pledged as security for the bonds. After a few years, County Q decides that it was not cut out for hospital operations, and sells the hospital to State Q's Hospital Authority. (These entities are not related under section 168(h)(4)(A).) State Q assumes the bond liability and substitutes its name as obligor. No other terms of the bonds are changed.

Does this change constitute a reissuance? Cite your source. If this is a deemed reissuance, is it a current refunding?

Continued on next page

Exercise 6

County S issues $25,000,000 of bonds in 1991 @ 9 percent. The bonds mature in 2006. The bonds are callable at 102 percent in 1998, and contain a defeasance provision in the indenture. In 1996, the county issues $18,000,000 10-year bonds at 3 percent. The proceeds from the 1996 issue are invested in special government securities and placed into an escrow account to pay debt service on the 1991 issue until redemption in 1998.

Is this a reissuance? What is the status of the 1991 issue on the issuance date of the 1996 issue? Cite your source.

Exercise 7

County T has $15,000,000 of 6 percent fixed rate bonds outstanding on January 1, 1997. On June 1, 1998, the interest rate is lowered to 5.8 percent. On August 1, 2001, the interest rate is lowered to 5.65 percent.

Do either or both of these changes result in a significant modification? Cite your source.

Exercise 8

County M issues bonds in the principal amount of $15M on January 1, 1996. The bonds mature on June 15, 2026. The proceeds are loaned to N, to build a hospital. Repayments by N are pledged to pay debt service on the bonds. The average reasonably expected economic life of the project is 30 years. M agrees to purchase at par any bond tendered to the remarketing agent, on any interest payment date. Under the terms of the bonds, the interest rate is reset on each June 1 at the lowest rate that would enable the bonds to trade at par on that date.

Are these bonds qualified tender bonds? If not, are they tender bonds?

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Problem 1

County K issues $ 10,000,000 of 3 percent bonds at par on January 1, 1994. The bonds pay interest annually on January 1st and mature on January 1, 1999. On June 1, 1997, the parties agree to extend the maturity date of the bonds to June 1, 2001. They agree to raise the interest rate to 3.2 percent but the bondholders require a one-time payment of $700,000. The agreement is finalized on June 1, 1997 and the county makes the required payment on the same date.

Do these changes in bond terms constitute a significant modification?

END OF MODULE G

Exhibit G-1