The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

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Notice 2008-27 Addresses Reissuance Standards for Municipal Bonds, Including Auction Rate Bonds; Comments Requested

[22291]

March 11, 2008

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 5-08
FIXED-INCOME ADVISORY COMMITTEE No. 8-08
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 4-08
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 12-08
TAX COMMITTEE No. 10-08 RE: NOTICE 2008-27 ADDRESSES REISSUANCE STANDARDS FOR MUNICIPAL BONDS, INCLUDING AUCTION RATE BONDS; COMMENTS REQUESTED

Internal Revenue Service (“IRS”) Notice 2008-27 (attached) provides interim guidance until Treasury issues regulations to clarify when tax-exempt bonds are treated as reissued or retired. The Notice states that it is intended in part to address certain market concerns resulting from recent rating agency downgrades of major municipal insurers and auction failures in the auction rate bond sector.

The Notice provides increased flexibility to state and local bond issuers in restructuring their auction rate and other exempt bonds. Specifically, the Notice modifies certain reissuance standards under Notice 88-130 and clarifies that auction rate bonds may be “qualified tender bonds.” The Notice also modifies the application of the debt modification regulations under section 1001 to tax-exempt bonds, including auction rate bonds. Finally, the Notice provides three special rules for certain nonrecourse debt, temporary waivers of interest rate caps and certain modifications of qualified hedges.

A. Modifications to Notice 88-130 and Regulation 1.1001-3

The Notice first addresses situations in which a tax-exempt bond's terms may be modified without the modifications potentially causing the bond to be treated as reissued under Code section 1001.

1. Modifications to Notice 88-130

Notice 2008-27 modifies Notice 88-130, which provides special rules for determining when "qualified tender bonds" (sometimes called "variable rate demand bonds") are treated as reissued. Notice 88-130 generally provides that qualified tender bonds are not treated as reissued as a result of certain tender rights and certain changes in interest rate modes and other bond terms that are covered specifically by the detailed rules and limitations set forth therein.

Notice 2008-27 clarifies that auction rate bonds may be "qualified tender bonds." For qualified tender bonds (including auction rate bonds), a "qualified interest rate mode change" and a "qualified tender " are not modifications under section 1.1001-3. Therefore, a qualified tender bond (including an auction rate bond) is not treated as reissued or retired solely as a result of a qualified interest rate mode change or the existence or exercise of any qualified tender.

2. Interest Rate Variance

The Notice clarifies that an interest rate variance directly related to a qualified interest rate mode change is not a modification of a tax-exempt bond. Thus, issuers do not need to test the variances under the "change-in yield" rules used to determine significant modifications.

3. Definitions Applicable to Modifications of Notice 88-130 and Regulation 1.1001-3

a. Qualified Tender Bond. A "qualified tender bond" is a tax-exempt bond that is part of an issue that has all of the following features:

(i) for each interest rate mode that is preauthorized under the bond's terms considered separately, the bond bears interest during the allowable term of that interest rate mode at either a fixed interest rate or a variable interest rate that constitutes a qualified floating rate on a variable rate debt instrument for a tax-exempt bond under section 1.1275-5(e) (including interest rates determined using a Dutch auction process);

(ii) the bond's interest is unconditionally payable at periodic intervals at least annually; and

(iii) the bond's final maturity date is no longer than the lesser of 40 years after the bond's issue date or the latest date that is reasonably expected as of the bond's issue date to be necessary to carry out the bond's governmental purpose (the 120 percent weighted average economic life of financed facilities test under section 147(b)is a safe harbor for this purpose).

b. Qualified Interest Rate Mode Change. A "qualified interest rate mode change" is a change in a bond's interest rate mode that is authorized under the bond's terms upon its original issuance. The bond's terms must require that the bond be resold at a price equal to par upon conversion to a new interest rate mode. However, upon a conversion to an interest rate mode that is a fixed interest rate for the bond's remaining term to maturity, the bond may be resold at a market premium or a market discount from the bond's stated principal amount.

c. Qualified Tender. A "qualified tender" is either a tender option or a mandatory tender requirement that is authorized under the bond's terms upon its original issuance and satisfies Notice 2008-27. A bond is subject to a tender option or a tender requirement if the bondholder either has the option at specified times or the mandatory requirement upon specified occurrences to tender the bond for purchase or redemption at a price equal to par (which may include any accrued interest) pursuant to the bond's terms on one or more tender dates before the final stated maturity date.

A purchase of a bond pursuant to a tender option or mandatory tender requirement is treated as part of a qualified tender if (i) the purchase occurs under the bond's terms (regardless of whether the purchase is by the issuer, a liquidity provider, a remarketing agent, a bond trustee, a conduit borrower, or an agent of any of them); (ii) the terms of the bond require that at least best efforts be used to remarket the bond; and (iii) the bond is remarketed no later than 90 days after the purchase date.

4. Examples

Example 1 describes tax-exempt bonds bearing interest at an auction rate that mature in 40 years. The bonds meet the definition of a qualified tender bond. The bonds are secured under a bond-insurance policy provided by an AAA-rated bond insurer. The AAA-rated insurer's credit rating is downgraded to an AA rating, which causes the auction rate on the bonds to set at 10%. The issuer replaces the now AA-rated bond insurance with an AAA-rated bank letter of credit, which causes the auction rate on the bonds to float down to 3%.

Because the change in credit enhancement in Example 1 did not cause a change in payment expectations on the bonds (i.e., the bonds had an investment grade payment expectation before and after the change in credit enhancement), the change is not a significant modification and does not cause a reissuance. The downward float in interest rate resulting from the change in credit enhancement is not required to be tested under the 25-basis point change in yield rule of section 1.1001-3 because the issuer made no change to the interest rate-setting mechanism under the bonds' terms.

Examples 2 and 3 clarify that no significant modification results under similar facts as in Example 1 if the issuer (i) exchanges the bonds with the downgraded credit enhancement for A-rated new bonds or (ii) exercises its options under the bonds' terms to convert the interest rate mode from an auction rate to a fixed interest rate for the remaining bond term (accompanied by a qualified tender).

Example 4 describes bonds similar the bonds in Example 1, except that the bonds' terms do not provide for any conversions of interest rate modes. The issuer addresses the downgrading of the bonds' credit enhancement by amending the bonds' documents to allow a conversion from an auction rate mode to a long-term fixed interest rate to maturity. The issuer then exercises its option under the amended terms to convert the bonds' interest rate mode from an auction rate to a fixed interest rate of 5% for the remaining bond term (accompanied by a mandatory bond tender).

Because Example 4's interest rate mode change is not pursuant to the bonds' terms when originally issued, the change is not a qualified interest rate mode change under Notice 2008-27. Also, the tender of the bonds is not pursuant to the bonds' terms as originally issued, and therefore is not a qualified tender. An issuer would analyze the facts described in Example 4 under section 1.1001-3 to determine whether changes are a significant modification.

B. Special Rules

1. Nonrecourse Debt. In applying section 1.1001-3(e)(4)(iv)(B) to determine whether a modification of the security or credit enhancement on a tax-exempt bond that is a nonrecourse debt instrument is a significant modification, Notice 2008-27 treats such a modification as a significant modification only if the modification results in a change in payment expectations under section 1.1001-3(e)(4)(vi).

2. Certain Waivers of Interest Rate Caps on Auction Rate Bonds. In applying section 1.1001-3(e)(2) to determine whether a modification to the yield on tax-exempt bonds that bear interest based on an auction rate constitutes a significant modification, Notice 2008-27 disregards a temporary waiver (in whole or in part) of the terms of a cap on the maximum interest rate on such auction rate bonds to the extent that any agreement to waive such a cap and the period during which such a waiver is in effect both are within the

period between November 1, 2007 and July 1, 2008. Except for the special relief provided in Notice 2008-27, an issuer generally must test a waiver of an interest rate cap on a tax-exempt bond under section 1.1001-3 to determine whether it causes a significant modification.

3. Certain Modifications of Qualified Hedges for Arbitrage Purposes. Solely for purposes of the arbitrage investment restrictions under section 148 in determining whether a modification of a qualified hedge results in a termination of the hedge under section 1.148-4(h), Notice 2008-27 provides that such a modification is not treated as a termination of the hedge if both:

> (a) the modification is not reasonably expected as of the modification date to change the yield on the affected hedged bonds over their remaining term by more than one quarter of one percent (.25 percent or twenty-five basis points) per annum; and
>
> (b) the payments and receipts on the qualified hedge, as modified, are fully taken into account as adjustments to the yield on those hedged bonds for arbitrage purposes under section 148.

C. Effective Date

Issuers of tax-exempt bonds may rely on Notice 2008-27 for any actions taken regarding tax-exempt bonds on or after November 1, 2007 and before the effective date of future regulations under section 150 that implement the Notice's guidance. Issuers also may continue to rely on Notice 88-130 until the effective date of future regulations.

The Notice does not address whether a debt modification described in the Notice would constitute an exchange for purposes of section 1001. The Notice also does not address whether similar consequences would result if a transaction falls outside the Notice's scope.

D. Comments Requested

The IRS has requested comments regarding Notice 2008-27. The due date for comments is May 19, 2008. Please provide any comments to the undersigned at lrobinson@ici.org or 202-326-5835 no later than close of business on Friday, April 18, 2008.

Lisa Robinson
Associate Counsel

Attachment (in .pdf format)