MEMO# 22386

April 3, 2008

IRS Revises Guidance on Reissuance Standards for Municipal Bonds, Including Auction Rate Bonds; Comments Requested

[22386]

April 3, 2008

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 13-08
FIXED-INCOME ADVISORY COMMITTEE No. 9-08
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 7-08
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 17-08
TAX COMMITTEE No. 11-08 RE: IRS REVISES GUIDANCE ON REISSUANCE STANDARDS FOR MUNICIPAL BONDS, INCLUDING AUCTION RATE BONDS; COMMENTS REQUESTED

Internal Revenue Service ("IRS") Notice 2008-41 (attached) revises and supersedes recently issued guidance (Notice 2008-27) [1] modifying Notice 88-130's reissuance standards for qualified tender bonds and providing that certain changes will not cause tax-exempt bonds to be treated as reissued or retired. The Notice 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.

Notice 2008-41 makes several changes to Notice 2008-27. First, the Notice clarifies and revises the qualified tender bond rules, including adding a temporary 180-day remarketing requirement. Second, the Notice allows a governmental issuer to buy its own tax-exempt auction rate bonds on a temporary basis without causing the debt represented by the purchased bonds to be retired or extinguished. Third, the Notice addresses the application of section 148's arbitrage investment restrictions to certain activities. Fourth, the Notice extends to October 1, 2008 the period during which interest rate caps may be waived without resulting in a significant modification under Reg. § 1.1001-3. Finally, the Notice amends the examples by (i) eliminating confusing language from Example 2, (ii) adding a variation to Example 3 that is treated as a modification, and (iii) adding a new Example 5 that illustrates the temporary 180-day qualified tender bond remarketing requirement.

A. Qualified Tender Bond Rules

Regarding the qualified tender bond rules, the Notice makes the following changes:

1. clarifies that a determination of whether a bond is a "qualified tender bond" is made on a bond-by-bond basis, except to the extent that the determination requires the use of the weighted average maturity of the entire issue;
2. expands the list of eligible reference interest rates to include a qualified inflation rate or a qualified inverse floating rate under Reg. § 1.1275-5(c)(5); and
3. clarifies how the 90-day remarketing requirement in the definition of a "qualified tender right" operates and adds a temporary 180-day remarketing requirement.

(a) Remarketing Requirements (90-Day and 180-Day Rules)

The qualified tender bond rules require that such a bond be subject to an optional tender right or a mandatory tender requirement that allows or requires a bondholder to tender the bond for purchase in one or more prescribed circumstances under the bond's terms. The tender right must entitle a tendering bondholder to receive a purchase price equal to par (which may include any accrued interest). The terms of the tender right must require the issuer or its remarketing agent to use at least best efforts to remarket a bond upon a purchase pursuant to the tender right.

The Notice generally provides that a bond purchased by or on behalf of a governmental issuer pursuant to a qualified tender right will not be treated as retired as a result of the qualified tender right until the end of the 90-day period beginning from the date of such purchase. After the end of this 90-day period, a governmental issuer generally cannot hold its own bond without causing a retirement of the bond.

The 90-day remarketing period is extended to 180 days for any purchase by or on behalf of a governmental issuer pursuant to a qualified tender right that occurs before October 1, 2008. During this 180-day period, a governmental issuer or its agent may hold the bond under the terms of the bond without causing a retirement of the bond. Since the bond is treated as outstanding during this 180-day period, the governmental issuer also may refund the bond with a refunding bond during this period upon a failed remarketing.

(b) Definition of Governmental Issuer

The Notice defines a "governmental issuer" as “an issuer of a tax-exempt bond that is a governmental unit or an agency or instrumentality thereof.” The Notice does not treat third-party guarantors, third-party liquidity facility providers, and conduit borrowers (other than a conduit borrower that is a governmental issuer) as purchasers by or on behalf of a governmental issuer.

Non-governmental entities may hold a bond purchased pursuant to the exercise of a qualified tender right for an unlimited holding period without causing a retirement of such bond. The Notice permits a governmental issuer to (i) hold a bond purchased before October 1, 2008 pursuant to the exercise of a qualified tender right for a holding period of up to 179 days while using best efforts under the bond’s terms to remarket the bond; and (ii) then resell the bond to a third-party guarantor, third-party liquidity facility provider, or other independent third party before the 180-day period expires.

(c) New Example Illustrating the 180-Day Remarketing Requirement

Example 5 describes tax-exempt bonds bearing interest initially at a variable rate demand rate that mature in 40 years. The bonds meet the definition of a qualified tender bond. The bonds are secured by both a third-party liquidity facility via a bank letter of credit and a bond insurance policy. An investment bank serves as the remarketing agent. On May 1, 2008, the governmental issuer converts the bonds’ interest rate to a fixed interest rate to maturity and the bonds are subject to a mandatory tender offer. The terms of the liquidity facility require that the bank fund the qualified tender right by receiving a pledge of the bonds as collateral. The issuer (not the bank) actually holds the bonds upon a draw on the liquidity facility.

During the 180-day period after the date the bonds are purchased pursuant to the qualified tender right, the issuer and the remarketing agent are unsuccessful in remarketing the bonds as a result of difficult market conditions and despite their best efforts. The Notice treats the bonds as outstanding and not retired during the 180-day period, even if the bonds are held by or on behalf of the issuer. Since the bonds are treated as outstanding during this 180-day period, the issuer may refund the bonds with proceeds from refunding bonds or resell the bonds to a third party.

Under a second variation of the example, the issuer retains the bonds beyond the 180-day permitted holding period. The Notice treats the bonds as retired as of the end of the 180th day from and after the date of the bonds’ purchase. The count of the issuer’s 180-day permitted holding period starts on the date of the purchase pursuant to the qualified tender right (May 1, 2008) and ends at the end of the 180th day from and after the date of purchase (at the end of the day on October 27, 2008).

Under a third variation of the example, the terms of the liquidity facility provide that the bank will hold the bonds rather than merely receive a pledge of the bonds as collateral. The Notice does not treat a third-party liquidity facility provider as a purchaser by or on behalf of a governmental issuer. Thus, the bank may hold the bonds during and beyond the 180-day period after the date of the purchase pursuant to the qualified tender right without causing a retirement of the bonds.

Under a fourth variation of the example, the issuer holds the bonds for 179 days after purchase pursuant to the exercise of a qualified tender right. The issuer uses best efforts to remarket the bond, and then sells the bonds to the bank pursuant to the liquidity facility. The Notice does not treat this transaction as a retirement of the bonds.

B. Bond Purchases By Governmental Issuers

The Notice adds a rule that permits a governmental issuer to purchase its own tax-exempt auction rate bond on a temporary basis without resulting in a reissuance or retirement of the bond if the governmental issuer (i) holds the bond for not more than a 180-day period from and after the purchase date; and (ii) purchases the bond before October 1, 2008. This rule is similar to the temporary 180-day remarketing requirement for qualified tender bonds. Since the auction rate bond is not treated as retired during the 180-day period, the governmental issuer may refund the bond with a refunding bond, tender the bond for purchase in a qualified tender right in its capacity as a bondholder, or otherwise resell the bond. After the end of the 180-day period, a governmental issuer generally cannot hold its own auction rate bond without causing a retirement of the bond.

C. Application of Section 148’s Arbitrage Investment Restrictions

The Notice adds rules that address the application of section 148’s arbitrage investment restrictions to qualified hedges, tax-exempt bond purchases by conduit borrowers, and bond sales at a market premium pursuant to a qualified interest rate mode change. The Notice amends Notice 2008-27’s arbitrage rule regarding the treatment of minor modifications of qualified hedges by providing that a deemed termination of an otherwise qualified hedge under section 1.148-4(h) will not result from bonds being held by or on behalf of a governmental issuer during (i) the 90-day remarketing period or the temporary 180-day remarketing period pursuant to a qualified tender right; or (ii) the 180-day holding period for temporary purchases of auction rate bonds.

Regarding a conduit borrower's purchase of tax-exempt bonds, the Notice provides that if a borrower purchases a tax-exempt auction rate bond that financed its loan to facilitate liquidity under adverse market conditions, then the purchase will not cause a violation of a technical arbitrage restriction against purchases of tax-exempt bonds by conduit borrowers under Reg. § 1.148-1(b)'s "program investment" definition.

Regarding certain permitted resales of bonds at a market premium upon a conversion of the interest rate on a qualified tender bond to a fixed interest rate to maturity, the Notice provides that, solely for arbitrage purposes, any premium properly received by an issuer pursuant to a qualified interest rate mode change will be treated as additional sale proceeds (as defined in Reg. § 1.148-1(b)).

D. Extension of Period For Waiver of Interest Rate Caps

The Notice extends until October 1, 2008 the period during which interest rate caps may be waived without resulting in a significant modification under Reg. § 1.1001-3.

E. Revisions and Additions to Examples

The Notice eliminates the last sentence of Example 2. The Notice also adds a variation to the facts described in Example 3. The facts are the same except that the issuer replaces a term bond that has a prescribed mandatory sinking fund redemption schedule with alternative bonds with serial maturities. The "serialization" of the term bond does not directly result from the qualified interest rate mode change and therefore generally would be a modification under Reg. § 1.1001-3. Finally, the Notice adds a new Example 5 (discussed in Section A) to illustrate the temporary 180-day qualified tender bond remarketing requirement.

F. Effective Date

The Notice is effective as of March 25, 2008. Issuers of tax-exempt bonds may rely on Notice 2008-41 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. Notice 2008-27 is superseded and may not be relied upon after the effective date of Notice 2008-41.

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.

G. Comments Requested

The IRS has requested comments regarding Notice 2008-41. 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)

endnotes

[1] See Institute Memorandum (22291) 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, and Tax Committee No. 10-08, dated March 11, 2008.