

**MEMO# 22883**

September 19, 2008

# **IRS Notice Addresses Minimum Gain Share Percentage and Other Requirements for Tender Option Bonds; Comments Requested**

[22883]

September 19, 2008

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 31-08  
FIXED-INCOME ADVISORY COMMITTEE No. 25-08  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 23-08  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 35-08  
TAX COMMITTEE No. 30-08 RE: IRS NOTICE ADDRESSES MINIMUM GAIN SHARE  
PERCENTAGE AND OTHER REQUIREMENTS FOR TENDER OPTION BONDS; COMMENTS  
REQUESTED

The Internal Revenue Service (“IRS”) has released attached Notice 2008-80 (the “Notice”), which describes a proposed revenue procedure that would modify and supersede Rev. Proc. 2003-84, 2003-2 C.B. 1159 [\[1\]](#). As requested by the ICI [\[2\]](#), the proposed guidance clarifies that a synthetic tax-exempt variable rate instrument (synthetic muni) will not qualify as a partnership eligible for the monthly closing election described in Rev. Proc. 2003-84 unless, among other things, variable-rate interest holders receive at least five percent (5%) of any gain realized upon the sale or other disposition of any tax-exempt bond held by the partnership (“a 5% minimum gain share”). The proposed guidance also describes the common features of eligible partnerships and imposes certain additional eligibility conditions, which such partnerships must meet for purposes of the monthly closing election.

# Characteristics of Partnerships Covered by Proposed Guidance

The proposed guidance clarifies that the monthly closing election is intended to be available to partnerships with certain common features:

1. Variable-rate interests have characteristics of investment grade, highly-liquid, short-term tax-exempt bonds (e.g., interests are eligible investments for money market funds under Rule 2a-7 of the Investment Company Act of 1940).
2. Variable-rate interest holders generally invest a substantial majority of the capital in the partnership (e.g., often 99 percent of such capital) and inverse interest holders invest the balance of such capital.
3. Variable-rate interest holders generally are protected substantially against losing their capital investment, plus accrued distributive shares in the partnership, by short-term tender option rights (e.g., seven-day demand purchase options) supported by a creditworthy liquidity provider. The liquidity provider may be an unrelated third party, an affiliate of the partnership's sponsor, or the inverse interest holder.
4. If it purchases variable-rate interests under the liquidity facility, the liquidity provider typically has rights to reimbursement either from the inverse interest holder or from sales of partnership assets in its capacity as a partner. The variable-rate interest holders, however, typically are not fully protected against risk of loss of their capital investments because their tender options terminate if certain extraordinary events occur.
5. The partnership's primary purpose is to invest in a relatively fixed portfolio of investments in tax-exempt bonds (in contrast to a partnership that primarily engages in an active bond trading business).

## Additional Eligibility Conditions

The proposed guidance imposes additional eligibility conditions on partnerships for making a monthly closing election. These requirements relate to (1) tender option termination events, (2) the minimum gain share payable to variable-interest holders, and (3) the maturity date by which variable-interest holders must have a right to realize such gains.

## **Tender Option Termination Events**

The proposed guidance provides that the tender option or put option rights of variable-rate interest holders are subject to termination without notice if one of the following events occurs:

1. a bankruptcy filing by or against a tax-exempt bond issuer;
2. a downgrade in the credit rating of a tax-exempt bond and a downgrade in the credit rating of any guarantor of the tax-exempt bond, if applicable, to a rating or ratings, as applicable, below investment grade;
3. a payment default on a tax-exempt bond; or
4. a final judicial determination or a final IRS administrative determination of taxability of a tax-exempt bond for Federal income tax purposes under Code section 103.

## **Five-Percent Minimum Gain Share**

The proposed guidance provides that the variable-rate interest holders shall have the right to receive a minimum gain share of not less than five percent (5%) of any gain upon the sale or other disposition of any tax-exempt bond held by the partnership. The partnership shall pay each required gain share to the variable-rate interest holders by distributing the proceeds of the sale or other disposition within a reasonable period.

## **Bond Maturity Date for Variable-Interest Holders' Right to Realize Gains**

The proposed guidance requires that the partnership terminate or otherwise provide variable-rate interest holders with a right to require a sale, redemption, or other disposition of the partnership's tax-exempt bonds, including attendant gain share realization potential, by a specific date. This potential realization date must be no later than the date that represents 80 percent of the remaining weighted average maturity ("WAM") of the tax-exempt bonds held by the partnership, measured from the date of the partnership's acquisition of the tax-exempt bonds ("80 Percent WAM Test"). The date of acquisition may be determined in any reasonable manner consistent with the parameters of the test. The 80 Percent WAM Test is intended to give variable-rate interest holders a reasonable

opportunity to realize potential appreciation in the value of the tax-exempt bonds held by the partnership.

For purposes of the 80 Percent WAM Test, a bond's WAM generally shall be determined in a manner similar to the determination of WAM under Code section 147(b). WAM generally must be determined based on issue prices and mandatory sinking fund redemptions, with additional adjustments for (i) optional redemptions at the first optional par redemption date and (ii) the partnership's date or dates of acquisition of the tax-exempt bonds.

Any reasonable, consistently applied measure may be used to weight the bonds in lieu of issue price, if different than the partnership's acquisition price (e.g., issue price, principal amount, cost, or fair market value). A partnership may apply the 80 Percent WAM test either separately on a "bond-by-bond" basis to each group of substantially identical tax-exempt bonds of the same maturity within the same "issue" (as defined in Code section 1.150-1(c)) held by the partnership, or collectively on a "portfolio" basis to all tax-exempt bonds held by the partnership.

## **Effective Date**

The Notice is effective beginning on September 17, 2008.

The proposed guidance generally will apply prospectively to partnerships with a start-up date on or after the date that is thirty days after final guidance is released. The proposed guidance also will apply to any partnership without regard to its start-up date if new capital is originally contributed to the partnership on or after the date that is thirty days after final guidance is released in an amount that has an aggregate fair market value greater than ten percent (10%) of the aggregate fair market value of the total assets owned by the partnership on the day before the date that is thirty days after final guidance is released. This "ten percent capital contribution" rule does not apply to deemed capital contributions to a reconstituted partnership as a result of a partnership termination under Code section 708(b)(1)(B).

The grandfathering rules in section 9.02 of Rev. Proc. 2003-84 continue to apply. Also, the proposed guidance shall apply to partnerships addressed by Notice 2008-55 (partnerships holding auction rate preferred stock and with certain prescribed liquidity facilities) as the successor to Rev. Proc. 2003-84, except that the proposed guidance's rules regarding tender option termination events and the 80 Percent WAM Test shall be inapplicable.

Eligible partnerships may rely immediately on the proposed guidance to make monthly

closing elections effective for any elections made on or after September 17, 2008. Eligible partnerships also may continue to rely on Rev. Proc. 2003-84 until the proposed guidance is finalized.

## Comments Requested

The IRS requests general comments regarding the Notice, including comments on ways to facilitate market innovation consistent with promoting administrative certainty and sound tax policy. The IRS also requests specific comments, including whether and under what circumstances the proposed guidance should:

- apply when the variable interest holder has a minimum gain share percentage of less than five percent (e.g., when the variable-rate interest holders receive particular rights to control sales of underlying tax-exempt bond assets held by a tax-exempt bond partnership);
- be expanded to allow qualifying income from assets beyond original assets of the partnership referred to in Code section 4.02(3) of the proposed guidance; and
- be expanded to allow application to any other types of transactions besides the contemplated tax-exempt bond partnerships.

Comments are due to the IRS by December 15, 2008. Please provide comments to Lisa Robinson ([lrobinson@ici.org](mailto:lrobinson@ici.org) or 202-326-5835) no later than November 28, 2008.

Lisa Robinson  
Associate Counsel

[Attachment \(in .pdf format\)](#)

### endnotes

[1] See Institute [Memorandum](#) (16745) to Tax Members No. 60-03, Money Market Funds Advisory Committee No. 18-03, and Fixed-Income Advisory Committee No. 16-03, dated November 6, 2003.

[2] See Institute [Memorandum](#) (22434) to Closed-End Investment Company Members No. 14-08, Fixed-Income Advisory Committee No. 10-08, Money Market Funds Advisory Committee No. 8-08, Municipal Securities Advisory Committee No. 19-08 and Tax Members No. 13-08, dated April 21, 2008.

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