

TO: Clients

FROM: Nixon Peabody

DATE: February 20, 2008

RE: New IRS guidance on reissuance rules for variable rated demand bonds and auction rate securities

As a result of the recent problems in the market for auction rate securities (“ARS”) and, to a lesser extent, insured variable rate demand obligations (“VRDOs”), issuers have been considering converting those securities to different interest rate modes or otherwise refinancing these bonds. On February 20, 2008, the IRS released Notice 2008-27 (the “Notice”), which is intended to provide relief and additional guidance regarding the tax consequences of these transactions. In particular, the Notice provides guidance concerning: (1) when outstanding ARS and VRDOs will be considered retired and new bonds issued (a “reissuance”) for tax purposes as a result of an interest rate mode conversion, (2) when other forms of refinancings will result in a reissuance, and (3) whether these types of conversions and refinancings will result in adverse tax consequences for related interest rate swaps.

Summary. The Notice provides new rules under which most conversions of interest rate modes that occur pursuant to the original terms of the applicable bond documents will not result in a reissuance of those bonds, even if other changes to those bonds occur at the same time as the conversion. Thus, for example, the conversion of bonds from an ARS mode to a fixed rate to maturity that occurs under the existing bond documents will not result in a reissuance even if, at the same time, the issuer adds or eliminates credit enhancement for those bonds or modifies the amortization schedule for those bonds. In the case of the actual issuance of new bonds to retire existing ARS bonds, the Notice provides that no reissuance will occur if the transaction occurs in the context of an exchange of new bonds for the old bonds. Finally, the Notice provides new rules to eliminate the need for interest rate swaps to be marked to market or to be retested for so-called “qualified hedge” treatment where the change to the swap rate is expected to be less than 25 basis points. These provisions are described below.

Background on refundings and reissuance. If an outstanding tax-exempt bond is retired in connection with a refunding, various tax requirements must be met for the refunding bonds, as well as the refunded bonds. Generally, the refunding bonds will only

be tax-exempt if those bonds satisfy the then-applicable rules for issuance of tax-exempt bonds and bond counsel will have to render a tax opinion to that affect, after performing the necessary due diligence. Various procedural requirements will also have to be met, including the payment of rebate for the bonds being retired and, for the new bonds, the filing of a new IRS Form 8038. Changes in law and other requirements may prevent the refunding bonds from being issued on a tax-exempt basis.

The tax law consequences applicable to refundings may also apply when the terms of an outstanding bond are modified sufficiently to cause a reissuance of the bond (for example, through a renegotiation of the interest rate on an outstanding bond by more than 25 basis points). The rules for determining whether a reissuance has occurred generally involve an analysis of whether a “modification” has occurred and whether that modification is “significant.” Under these rules, for example, issuers of recourse tax-exempt bonds are free to modify, eliminate, or add credit enhancement without causing a reissuance. Special reissuance rules for “qualified tender bonds” have long applied to most multi-modal VRDOs, with those rules generally permitting changes in the applicable interest rate mode to occur as long as no other discretionary changes to the terms of the bonds occur at the same time. For example, an issuer could convert a multi-modal VRDO from 7-day mode to a fixed rate to maturity without a reissuance occurring unless, at the same time, the issuer changes the amortization schedule or eliminates the bond insurance for those bonds. In some respects, the reissuance rules for multi-modal VRDOs have been more restrictive than for other types of bonds. In addition, the application of the special rules for multi-modal bonds to ARS is somewhat unclear.

New rules for interest rate mode conversions. The Notice makes several important changes to the reissuance rules for tax-exempt VRDOs and ARS.

- The Notice clarifies that ARS are treated as qualified tender bonds and in the same manner as other short-term rate modes in a VRDO structure. The Notice also clarifies that, both for ARS and VRDOs, changes in interest rate modes provided for under the bond documents will not result in a reissuance.
- If, in connection with an interest rate mode change, other changes to the terms of the bonds occur, such as changes in amortization or credit enhancement, those changes are separately analyzed under the general reissuance rules. Under the general reissuance rules, most changes in amortization (other than certain extensions of maturity) or credit enhancement will not result in a reissuance. The Notice also eliminates the only significant exception to this rule, under which changes in credit enhancement in the context of a conduit financing where the bondholders’ security does not provide recourse to either the issuer or the conduit borrower resulted in a reissuance. Under the Notice, such a change will not result in a reissuance if there is no change in payment expectations following the change.
- Although changes in interest rate can ordinarily result in a reissuance, the Notice clarifies that changes in interest rates that occur as part of an interest rate mode

conversion or that result from another permitted change in a bond, such as changes in credit enhancement, will not result in a reissuance. Moreover, temporary changes in the maximum rate paid for ARS will not result in a reissuance if the change applies during the period November 1, 2007 through July 1, 2008.

- The Notice makes several changes to the restrictions applicable to VRDOs and ARS: First, the Notice permits the remarketing of such bonds in a pre-authorized fixed rate to maturity at a premium or a discount (rather than at par); other remarketings must be made at par. The permitted maturity of an ARS or VRDO has been extended to the lesser of 40 years and the latest date necessary to carry out the governmental purpose of the bond issue. Finally, in the event of a failed remarketing, the bond can be held for up to 90 days by the issuer, a liquidity provider, remarketing agent, bond trustee, conduit borrower, or an agent of such parties as long as best efforts must be used to remarket the bond (the prior rules allowed bonds to be held for only 30 days).

As a result of these changes and clarifications, if the changes in interest rate mode on a bond occur under the existing bond terms, there is substantial flexibility to make changes to ARS or VRDOs without causing a reissuance. However, certain changes are not covered by the Notice and may result in a reissuance, such as, the addition of a new interest rate mode or a permanent increase in the maximum rate payable for an ARS.

Refunding transactions and exchanges of bonds. In contrast to the relief provided for interest rate mode changes for multi-modal bonds, the Notice provides only limited relief for transactions that involve the actual issuance of new refunding bonds. As a result, if new bonds are issued to refinance outstanding ARS or VRDOs, the new bonds will be treated as a refunding and those new bonds will have to comply with the rules applicable to new bond issuances. The only exception to this rule provided by the Notice is a clarification that if the new bonds are issued as part of an exchange of those new bonds with the holders of the outstanding bonds, that transaction is analyzed under the rules described above for reissuance; if the new bonds do not involve a significant modification when compared to the old bonds, a reissuance will not result. The IRS issued this clarification to benefit issuers attempting to eliminate bond insurance as part of an interest rate mode conversion in circumstances where new bonds must be issued in order to eliminate the insurance. The Notice also provides that the exchange can be affected using a third party intermediary who is not acting as the issuer's agent.

Modifications of rules for interest rate swaps. The arbitrage regulations provide that interest rate swaps meeting certain requirements are "integrated" with the related bonds for purposes of computing the yield on those bonds, with the yield computed taking into account the payments on the swap. "Regular" integration results in the floating and fixed payments on the swap (together with the interest paid on the bonds) being taken into account in computing the yield on the bonds, with the bonds treated as variable yield bonds (that is, the yield for arbitrage purposes is not fixed for the term of the issue). "Super-integration" results in the bonds being treated as fixed yield bonds

based on the fixed rate on the swap. If bonds with a qualified hedge are refunded or reissued, the swap is treated as terminated at its fair market value. A material change to an interest rate swap will also result in a deemed termination of the swap. The deemed termination of swaps can result in substantial tax complexities for the bonds.

Many ARS and VRDOs have integrated interest rate swaps in place. The Notice makes modest changes to the rules for interest rate swaps obtained in connection with ARS or VRDOs. Most significantly, if ARS or VRDOs are not reissued, generally there will be no tax consequences for the interest rate swaps and no deemed termination of the swaps. There may, however, be a need to retest the swap for continued qualified hedge status taking into account the new interest rate mode. In addition, if the interest rate on a qualified hedge is modified by an amount not expected to exceed 25 basis points over the term of the hedge, that change will not result in the deemed termination of the swap, as long as all payments and receipts on the swap are taken into account in computing bond yield.

Applicability and effective date. The provisions of the Notice are effectively elective for actions taken on or after November 1, 2007. However, issuers may, in the alternative, choose to apply the prior IRS guidance on these matters. The IRS is seeking comments with respect to the new rules in the Notice. The Notice represents a very timely and helpful response by the IRS to requests for guidance concerning tax questions that have arisen in connection with auction rate securities. Despite this, given the wide variety of situations that will arise, the Notice could not answer every question that will arise as issuers seek to move out of auction rate securities.

* * * * *

To ensure compliance with IRS requirements, we inform you that any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.