

Part III – Administrative, Procedural, and Miscellaneous

Reissuance Standards for State and Local Bonds

**Notice 2008-27**

**SECTION 1. Purpose.** The Internal Revenue Service (“IRS”) and the Treasury Department expect to issue regulations under §150 of the Internal Revenue Code of 1986 to modify and clarify the determination of when tax-exempt bonds are treated as reissued or retired solely for purposes of §103 and §§141 through 150. This Notice provides interim guidance until the promulgation of such regulations. This Notice modifies certain special reissuance standards for “qualified tender bonds” under IRS Notice 88-130, 1988-2 C.B. 530. This Notice also modifies certain aspects of the application of §1.1001-3 of the Income Tax Regulations on debt modifications as they apply to tax-exempt bonds solely for purposes of §103 and §§141 through 150. This Notice provides three special rules which address certain temporary waivers of interest rate caps, certain nonrecourse debt, and certain modifications of qualified hedges. In part, this Notice is intended to provide greater certainty and flexibility to address certain potential Federal tax issues that have arisen in the tax-exempt bond market as a result of recent rating agency downgrades of major municipal bond insurers and failures of auctions in the auction rate bond sector of the tax-exempt bond market.

This Notice applies solely for purposes of §103 and §§141 through 150 of the Code. No inference should be drawn regarding whether a debt modification

described in this Notice would constitute an exchange for purposes of §1001 of the Code. In addition, no inference should be drawn about whether similar consequences would obtain if a transaction falls outside the scope of this Notice.

This Notice invites public comment on the guidance provided herein.

## **SECTION 2. Background**

### **Reissuance**

Reissuance of a tax-exempt bond for purposes of the tax-exempt bond provisions triggers retesting of all the various program requirements for new issues of tax-exempt bonds. A reissuance of an issue of tax-exempt bonds may result in various negative consequences to a bond issuer, including, among other things, changes in yield for purposes of the arbitrage investment restrictions, acceleration of arbitrage rebate payment obligations, deemed terminations of integrated interest rate swaps under the qualified hedge rules for arbitrage purposes, new public approval requirements for qualified private activity bonds, and change in law risk.

In general, the standard for determining whether tax-exempt bonds are reissued, retired, or otherwise modified significantly enough to trigger a retesting of the program requirements for new issues of tax-exempt bonds under the tax-exempt bond provisions of the Code is based on the general Federal tax standards for debt exchanges under §1001 and regulations thereunder.

In general, §1.1001-3 of the Income Tax Regulations employs a significant modification standard to determine whether modifications to a debt instrument in any form are sufficiently significant to cause the debt instrument to be treated as

reissued or exchanged for purposes of §1001. Section 1.1001-3 applies to modifications in the form of amendments to the terms of an existing debt instrument and to modifications in the form of an actual exchange of an existing debt instrument for a different debt instrument. The determination of whether the resulting debt instrument is treated as a reissued new debt instrument or a continuation of the original debt instrument depends on whether the result represents a "significant modification" of the original debt instrument, as defined in §1.1001-3.

Notice 88-130 provides certain special reissuance rules for certain eligible tax-exempt bonds that are "qualified tender bonds," as defined therein. Notice 88-130 provides that qualified tender bonds will not be treated as reissued for purposes of §103 and §§141 through 150 as a result of certain tender rights and certain changes in interest rate modes and other terms of bonds that are covered specifically by the detailed rules and limitations set forth in Notice 88-130.

#### **Interest Rate Modes—Tender Option Modes and Auction Rate Modes**

Issuers may issue fixed rate tax-exempt bonds that bear interest at fixed rates to maturity or variable rate bonds that bear interest at variable rates which float periodically in accordance with various market-based interest-rate setting mechanisms. Issuers often include multi-modal interest rate features in the preauthorized terms of the bond documents which provide issuers with the flexibility to change interest rate modes under parameters set forth in the bond documents.

One common interest rate mode employed with tax-exempt bonds is a tender option mode. "Tender option bonds" are also referred to commonly as "variable rate demand bonds." Tender option bonds have short-term interest features tied to current market rates necessary to remarket the bonds at par. Tender option bonds have ongoing tender options or put options associated with the interest rate-setting mechanism which allow bondholders to tender their bonds for purchase at par at specified intervals, typically every seven days. Tender option bonds generally have creditworthy third-party liquidity facilities from banks or other liquidity providers to support the tender options and may have credit enhancement from bond insurers or other providers. Tender option bonds also may have interest mode conversion options which grant to the issuer or a conduit borrower an option to change the interest rate mode on the bonds from a tender option mode to another short-term interest rate mode or to a fixed interest rate to maturity. At the time of a conversion to another interest rate mode, tender option bonds typically are subject to a mandatory tender for purchase but a bondholder may be allowed to elect to retain the bonds. Upon the exercise of ongoing tender options associated with the short-term interest rate-setting mechanism for tender option bonds and upon any mandatory or optional tender upon conversion of the interest rate on the bonds to another interest rate mode, a remarketing agent or a liquidity provider typically will acquire the bonds subject to the tender at par and resell the bonds either to the same bondholders or to others willing to purchase such bonds. In general, Notice 88-130 provides guidance for when the tenders associated with tender

option bonds will not constitute reissuances if they meet the specific detailed eligibility requirements for "qualified tender bonds," as defined in Notice 88-130.

Another interest rate mode used with tax-exempt bonds is an auction rate mode. The interest rate on auction rate bonds is reset at predetermined intervals (generally under one year) using a modified Dutch auction process. Auction rate bonds generally trade at par and are callable at par on any interest payment date at the option of the issuer. Unlike bonds in a tender option mode, however, bonds in an auction rate mode have no ongoing tender options or put options to support the interest rate-setting process. Thus, auction rate bonds are viewed as long-term investments with a short-term interest rate-setting process. Auction rate bonds generally have maximum rates based on state law restrictions or certain formulas, such as a multiple of a tax-exempt or taxable index. Auction rate bonds may have credit enhancement from bond insurers or other providers. Auction rate bonds also may have interest mode conversion options similar to tender option bonds which grant to the issuer or a conduit borrower an option to change the interest rate mode on the bonds from an auction rate mode to another short-term interest rate mode or to a fixed interest rate to maturity. At the time of a conversion to another interest rate mode, auction rate bonds typically are subject to a mandatory tender for purchase in a process similar to mandatory tenders on conversions of interest rate modes used with tender option bonds. Questions have arisen regarding whether or to what extent auction rate bonds can be treated as qualified tender bonds for purposes of the provisions of Notice 88-130.

## **Approach of Guidance**

This Notice modifies and expands the protection afforded by Notice 88-130 to provide that authorized changes in additional interest rate modes and certain optional or mandatory tenders of the bonds will not result in a reissuance of the tax-exempt bonds solely for purposes of §103 and §§141 through 150. This Notice provides that other types of changes to tax-exempt bonds are tested for reissuance purposes under the significant modification standard under §1.1001-3. In addition, this Notice also provides special rules for certain issues that have arisen as a result of recent ratings downgrades of the bond insurers and auction failures on auction rate bonds.

### **SECTION 3. Scope and Application**

3.1. Scope and General Rules. The IRS and the Treasury Department expect to promulgate regulations under § 150 to provide guidance on whether tax-exempt bonds are treated as reissued or retired solely for purposes of §103 and §§141 through 150. Specifically, for purposes of §103 and §§141 through 150 only, in the case of a qualified tender bond (as defined herein), any qualified interest rate mode change (as defined herein) and any qualified tender (as defined herein) will not be treated as a modification under § 1.1001-3. Therefore, for these purposes, a qualified tender bond will not be 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. Further, in applying §1.1001-3 to modifications of tax-exempt bonds, any interest rate variance directly related to a qualified interest rate mode change will not be treated as a modification under

§ 1.1001-3, and thus such interest rate variances need not be tested under the change in yield rule for determining significant modifications under §1.1001-3(e)(2). Except as otherwise specially provided in this Notice, the determination of whether any modification to an issue of tax-exempt bonds causes a reissuance or retirement of the tax-exempt bonds for purposes of §103 and §§141 through 150 is based on whether the modifications are significant modifications under §1.1001-3.

Similar to the treatment under Notice 88-130, and except as expressly provided herein with respect to the treatment of "qualified interest rate mode changes" and "qualified tenders" on "qualified tender bonds" (all as redefined herein), a tax-exempt bond generally is treated as reissued or retired on the first date on which: (1) a significant modification to the terms of the bond occurs under §1.1001-3 or a disposition of the bond otherwise occurs under section 1001; (2) the bond is purchased or otherwise acquired by or on behalf of the issuer or a true obligor which is a governmental unit or an agency or instrumentality thereof; or (3) the bond is otherwise retired or redeemed. For these purposes, except as otherwise expressly provided herein, a bond is treated as purchased or otherwise acquired by or on behalf of a person if the bond is purchased or otherwise acquired (other than pursuant to the terms of a third party guarantee, liquidity facility, or remarketing arrangement) by that person in a manner that liquidates the bondholder's investment.

3.2. Definitions. The following definitions apply for purposes of this Notice only:

(1). Qualified Tender Bond. The term “qualified tender bond” means a tax-exempt bond that is part of an issue which has all of the following features:

(a) for each interest rate mode that is preauthorized under the terms of the bond 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 §1.1275-5(b) (e.g., various interest rate indexes and rate-setting mechanisms that reasonably can be expected to measure contemporaneous variations in the cost of newly-borrowed funds, including, without limitation, interest rates determined by reference to eligible interest rate indexes (e.g., the SIFMA index), tender option-based interest rate measures, or a Dutch auction process); (b) interest on the bond is unconditionally payable at periodic intervals at least annually; and (c) the final maturity date of the bond is no longer than the lesser of 40 years after the issue date of the bond or the latest date that is reasonably expected as of the issue date of the bond to be necessary to carry out the governmental purpose of the bond (with the 120 percent weighted average economic life of financed facilities test under Section 147(b) being treated as a safe harbor for this purpose).

(2). Qualified Interest Rate Mode Change. In general, a “qualified interest rate mode change” is a change in the interest rate mode on a bond that is authorized under the terms of the bond upon its original issuance. Further, in order to be a qualified interest rate mode change, the terms of the bond must require that the bond be resold at a price equal to par upon conversion to a new

interest rate mode, except that, upon a conversion to an interest rate mode that is a fixed interest rate for the remaining term of the bond to maturity, the bond may be resold at a market premium or a market discount from the stated principal amount of that bond.

(3). Qualified Tender. A “qualified tender” is either a tender option or a mandatory tender requirement that is authorized under the terms of the bond upon its original issuance and that meets the requirements of this Section 3.2(3). A bond is subject to a tender option or a tender requirement if the bondholder either has the option at specified times (e.g., an ongoing tender option as part of the interest rate-setting process for tender option bonds) or the mandatory requirement upon specified occurrences (e.g., a mandatory tender upon conversion from one interest rate mode to a different interest rate mode) to tender the bond for purchase or redemption at a price equal to par (which may include any accrued interest) pursuant to the terms of the bond 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 the purchase occurs under the terms of the bond (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), the terms of the bond require that at least best efforts be used to remarket the bond, and the bond is remarketed no later than 90 days after the date of such purchase.

3.3. Special Rule for Nonrecourse Debt. Solely for purposes of §103 and §§141 through 150, in applying §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, such a modification is treated as a significant modification only if the modification results in a change in payment expectations under §1.1001-3(e)(4)(vi).

3.4. Special Temporary Relief for Certain Waivers of Interest Rate Caps on Auction Rate Bonds. Solely for purposes of §103 and §§141 through 150, in applying §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, a temporary waiver, in whole or in part, of the terms of a cap on the maximum interest rate on such auction rate bonds is disregarded 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 this section, a waiver of a cap on an interest rate on a tax-exempt bond generally is required to be tested for whether it causes a significant modification under §1.1001-3.

3.5 Certain Modifications of Qualified Hedges for Arbitrage Purposes. Solely for purposes of the arbitrage investment restrictions under §148, in determining whether a modification of a qualified hedge results in a termination of the hedge under §1.148-4(h), such a modification is not treated as a termination of the hedge if both: (1) the modification is not reasonably expected as of the date of the modification to change the yield on the affected hedged bonds over the remaining term of the hedged bonds by more than one quarter of one percent (.25 percent or twenty-five basis points) per annum; and (2) 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 § 148.

3.6 Examples. The following examples illustrate the application of certain principles in this Notice and §1.1001-3 as they apply to tax-exempt bonds for purposes of this Notice.

Example 1. Insignificant Change in Credit Enhancement and Impact on Floating Interest Rate. On July 1, 2007, a municipality (the "Issuer") issued \$1 million in tax-exempt bonds that bear interest at an auction interest rate and that mature in 40 years (the "Bonds"). The Bonds are recourse obligations that are secured by the issuer's underlying primary A-rated investment grade credit. The Bonds are secured further by credit enhancement under a bond insurance policy provided by a AAA-rated bond insurer. Pursuant to the terms of the Bonds, the auction interest rate on the Bonds resets every 7 days. The terms of the Bonds grant the issuer the option to convert the interest rate mode on the Bonds from an auction rate mode to either a 7-day tender option rate mode or to a long-term fixed interest rate to maturity, subject to a mandatory tender of the Bonds upon such a conversion. The Bonds are qualified tender bonds under §3.2 of the Notice.

On January 3, 2008, the auction interest rate on the Bonds is set at 10% as a consequence of a downgrade in the bond insurer's credit rating from a AAA rating to a AA rating and associated market disruption. On January 10, 2008, the issuer amended the terms of the Bonds to replace the now AA-rated bond insurance with a AAA-rated bank letter of credit as credit enhancement, but otherwise made no other changes to the terms of the Bonds. On January 10, 2008, the auction rate on the Bonds floated down to 3% primarily as a result of the change in credit enhancement on the Bonds.

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The amendment to the terms of the Bonds to change the credit enhancement is a modification to a recourse debt instrument that must be tested for significance under the change in security or credit enhancement rule in §1.1001-3(e)(4)(iv). Because the change in security or credit enhancement 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), this change in credit enhancement is not a significant modification of the Bonds under §1.1001-3 and thus does not cause a reissuance of the Bonds under §103 and §§141 through 150. Further, the fact that the market impact of the change in credit enhancement caused the floating interest rate on the Bonds to float down from 10% to 3% is not required to be tested

under the 25-basis point change in yield rule for significant modifications under §1.1001-3(e)(2) because the Issuer has made no change to the interest rate-setting mechanism under the terms of the Bonds.

Example 2. Exchange of Bonds to Remove Bond Insurance. Assume the same facts as in Example 1 above, except that, instead of amending the terms of the existing Bonds (the "Old Bonds") to change the credit enhancement, on January 10, 2008, the Issuer issued new bonds with new Cusip numbers (the "New Bonds") and did an actual exchange of the New Bonds for the Old Bonds. The New Bonds are not backed by any bond insurance or other credit enhancement. The New Bonds without the bond insurance have an A credit rating. There are no other differences between the New Bonds and the Old Bonds. The result would be the same as in Example 1 and no reissuance of the Bonds would occur. Section 1.1001-3 applies the same significant modification standard to amendments to the terms of an existing debt instrument and to actual exchanges of an existing debt instruments for a different debt instrument. Further, the same modification analysis under §1.1001-3 would apply to an acquisition of an existing debt instrument for cash by an intermediary purchaser who is not an agent of or otherwise related to the issuer from an existing bondholder, an exchange of that acquired debt instrument for a modified debt instrument between such intermediary purchaser and the issuer and a subsequent sale by that intermediary purchaser to a different bondholder.

Example 3. Impact of Authorized Changes in Interest Rate Modes and Associated Mandatory Tenders. Assume the same facts as in Example 1 above, except that, on January 10, 2008, the Issuer also exercised its option under the terms of the Bonds to convert the interest rate mode on the Bonds from an auction rate mode to a fixed interest rate of 5% for the remaining term of the Bonds. The terms of the Bonds also required a mandatory tender and remarketing of the Bonds in connection with this interest rate mode change. The mandatory tender is a qualified tender and the change in the interest rate mode is a qualified interest rate mode change. Thus, the Bonds are qualified tender bonds, as defined in §3.2 of the Notice, the conversion of the interest rate on the Bonds from an auction rate mode to a fixed interest rate is pursuant to a qualified interest rate mode change" and the associated tender is qualified tender, all as defined in §3.2 of the Notice. Thus, under §3.1 of the Notice, in determining whether the Bonds are reissued for purposes of the tax-exempt bond provisions of the Code, the qualified interest rate mode change and the qualified tenders are not treated as modifications under §1.1001-3. Furthermore, the interest rate change on the Bonds from a floating auction rate of 10% to a fixed interest rate of 5% was directly related to the qualified interest rate mode change and, under §3.1 of the Notice, also is not treated as a modification under §1.1001-3. Finally, as in Example 1, no reissuance of the Bonds occurred for purposes of §103 and §§141 to §150 as a result of the change in credit enhancement.

Example 4. Impact of Unauthorized Changes. Assume the same facts as in Example 1, except that the terms of the Bonds do not provide for any conversions of the interest rate modes. On January 7, 2008, Issuer amends the Bond documents to allow the Issuer to convert the interest rate mode on the Bonds from an auction rate mode to either a 7-day tender option rate mode or to a long-term fixed interest rate to maturity, subject to a mandatory tender of the Bonds upon such a conversion. On January 10, 2008, Issuer exercised its option under the amended terms of the Bonds to convert the interest rate mode on the Bonds from an auction rate mode to a fixed interest rate of 5% for the remaining term of the Bonds. The Issuer also required a mandatory tender and remarketing of the Bonds in connection with this interest rate mode change.

Because the change in interest rate mode is not pursuant to the terms of the Bonds when originally issued, it is not a qualified interest rate mode change within the meaning of this Notice. Similarly, the tender of the Bonds on January 10, 2008 was not pursuant to the terms of the Bond as originally issued and therefore was not a qualified tender within the meaning of this Notice. Accordingly, the provisions of this Notice are not applicable either to the interest rate mode change on the Bonds or to the tender of the Bonds. Thus, to determine whether these modifications cause a reissuance or retirement of the Bonds for purposes of §103 and §§141 through §150, the impact of these modifications must be analyzed under §1.1001-3 to determine whether a significant modification of the terms of the Bonds occurred.

#### **SECTION 4. Interim Guidance and Reliance**

This Notice provides interim guidance. Issuers of tax-exempt bonds may rely on this Notice for any actions taken with respect to tax-exempt bonds on or after November 1, 2007 and before the effective date of future regulations under §150 that implement the guidance in this Notice. Issuers also may continue to rely on Notice 88-130 until the effective date of such future regulations. The IRS and the Treasury Department may amend or supplement the guidance in this Notice as circumstances warrant.

#### **SECTION 5. Request for Comments**

Before any notice of proposed rulemaking is issued with respect to the guidance provided in this Notice, consideration will be given to any written public

comments on this Notice that are submitted timely by May 19, 2008, and a signed original and eight (8) copies) of such comments should be sent to the IRS. Send submissions to: CC:PA:LPD:PR (NOT-), room 5203, IRS, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be sent electronically, via the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-118788-06). All comments will be available for public inspection and copying.

#### **SECTION 6. Drafting Information**

The principal author of this Notice is Aviva M. Roth, Office of the Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this Notice, contact Aviva M. Roth at (202) 622-3980 (not a toll-free call).